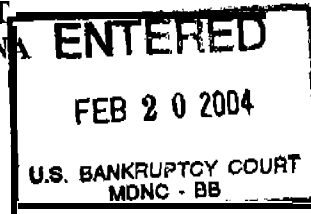


UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
DURHAM DIVISION



In re:)
)
E-Z Serve Convenience Stores,) Case No. 02-83 13 8
Inc., et al.,)
)
Debtors)
)
_____)
)
Louisiana Lottery Corporation)
)
v.) Ad. Proc. No. 03-9018
)
)
CIT Group Business Credit, Inc., and)
E-Z Serve Convenience Stores, Inc.,)
thru its Trustee, Richard Hutson)
_____)

MEMORANDUM OPINION

This matter came before the Court on December 2, 2003, after notice to all parties in interest, in Durham, North Carolina, upon cross motions for summary judgment, Anne Le Cour Neeb appeared on behalf of the Louisiana Lottery Corporation, John A. Northen appeared on behalf of the Trustee, and Kenneth R. Keller appeared on behalf of CIT Group Business Credit, Inc. This court has jurisdiction over this motion pursuant to 28 U.S.C. §§ 157 and 1334, and this matter is a core proceeding under 28 U.S.C. § 157(b)(2). The Court, after receiving the testimony and the exhibits and reviewing the file, makes the following findings of fact and conclusions of law pursuant to Rule 7052 of the Federal Rules of Bankruptcy Procedure.

BACKGROUND

This adversary proceeding arises out of the bankruptcy filing of E-Z Serve Convenience

Stores, Inc. (the “Debtor”), a group of companies (each individually referred to as a “Company”) that formerly operated a convenience store chain through direct ownership, indirect ownership and the lease of stores located throughout the southeastern United States. Prior to the bankruptcy filing, the Debtor owned approximately 197 store locations and leased approximately 454 other locations, including numerous stores located in Louisiana.

Prior to the bankruptcy filing, the Debtor and CIT Group Business Credit, Inc. (“CIT”) had entered into a Financing Agreement dated September 23, 1999, with several subsequent amendments, (collectively referred to as the “Financing Agreement”) pursuant to which CIT made loans and extended credit to the Debtor. CIT was secured by first priority perfected liens and security interests in certain assets and properties of the Debtor. Specifically, the Financing Agreement provided that, as security for payment of any loans or advances made to the Debtor, CIT would maintain a security interest in all of the Debtor’s inventory, accounts, documents of title, and general intangibles.

On September 18, 2001, the Debtor and the Louisiana Lottery Corporation (“Louisiana Lottery” or “LLC”) entered into an Instant Retailer Agreement Form (the “Lottery Contract”), pursuant to which the Debtor became licensed by the Louisiana Lottery to sell lottery tickets at its Louisiana convenience stores. Paragraph 13 of the Lottery Contract provides:

According to Louisiana statute, the retailer agrees to establish a separate lottery bank account (in an institution insured by the **FDIC**) for the sole purpose of retaining lottery ticket sales proceeds. The account will be capable of electronic funds transfer for the purpose of making payment to the LLC and receiving credits from the LLC, unless otherwise authorized in writing by the LLC.

To comply with the Lottery Contract, the Debtor set up a separate account (the “Lottery Account”) from which the Louisiana Lottery swept lottery ticket sale proceeds on a weekly

basis. The Louisiana Lottery did not monitor the lottery ticket proceeds between the time that they were collected by the lottery retailer and the time that they were swept from the Lottery Account. In fact, in this case, before lottery ticket proceeds were deposited into the Debtor's Lottery Account, the lottery ticket proceeds were deposited with all other proceeds from the sale of inventory into local depository accounts. The funds in the depository accounts were transferred to a consolidated blocked account, swept by CIT and applied to CIT loans. CIT then funded the Debtor's operating account and the Debtor then transferred money from the operating account into various accounts, including the account established for the Louisiana Lottery.

The Debtor filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on October 4, 2002. During the weeks preceding the petition date, the Debtor had collected \$251,512.71 in lottery ticket proceeds (the "Lottery Ticket Proceeds") which were deposited by the Debtor, transferred to the blocked account and applied to CIT loans. Shortly before the petition date, CIT stopped advancing money to the Debtor's operating account. The Debtor was unable to fund the Lottery Account and the Louisiana Lottery did not receive payment of the Lottery Ticket Proceeds. On October 7, 2002, an electronic draft in the amount of \$101,517.34 was returned to the Louisiana Lottery with an notation that the account was frozen. On October 10, 2002, an electronic draft in the amount of \$149,995.37 was returned to the Louisiana Lottery with the same notation.

The Louisiana Lottery contends that the Debtor also owed the amount of \$107,192.78 for "Unsettled Lottery Ticket Proceeds." In the Complaint, the Louisiana Lottery described this amount as "the net of credit given to the debtor for partial pack returns." In a Supplemental Memorandum filed on December 16, 2003, the Louisiana Lottery clarified that the amount

designated as Unsettled Lottery Ticket Proceeds represents proceeds collected by the Debtor for lottery tickets sold, but not yet invoiced by the Louisiana Lottery. **CIT disputes** whether or not the amount the Louisiana Lottery claims for Unsettled Lottery Ticket Proceeds represents funds that were actually collected by the Debtor, deposited into its account and swept by CIT.

On February 10, 2003, the **Louisiana** Lottery filed the present action to recover all Lottery Ticket Proceeds seized under Financing Agreement by CIT and all Unsettled Lottery Ticket Proceeds. The Louisiana Lottery alleges that the Debtor held the Lottery Ticket Proceeds in trust for the Louisiana Lottery, as provided by the Louisiana Lottery Act. See La. Rev. Statute 47:9055. The Louisiana Lottery contends that CIT gained possession of the Lottery Ticket Proceeds in breach of this trust. On October 31, 2003, the Louisiana Lottery filed a motion **for** summary judgment contending that there are no issues of material fact and **seeking** judgment as a matter **of law**. **CIT** denies any liability to the Louisiana Lottery and filed a motion for **summary** judgment seeking dismissal of the Complaint with respect to CIT.

Standard for Summary Judgment

The standard for summary judgment is set forth in Fed. R. Civ P. 56, which is made applicable to this proceeding by Bankruptcy Rule 7056, and provides that the movant will prevail on a motion for summary judgment if “the pleadings, depositions, answers to interrogatories, and admissions on file, together with affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter **of law**.” Fed. R. Civ. P. 56(c). See also Celotex Corp. v. Catrett, 477 U.S. 317, 106 S. Ct. 2548, 91 L.Ed. 2d 265 (1986). The movant has the initial burden of establishing that there is an absence of any genuine issue of material fact, and all reasonable inferences must be drawn in

favor of the **nonmoving** party. Id. Once the moving party satisfies that burden, the burden shifts to the nonmoving party to present some evidence of a genuine issue of material fact. Id. To meet its burden, the nonmoving party is required to present **evidentiary** support for every essential element of its case and upon which it bears the burden of proof at trial. Id. The nonmoving party cannot “create a genuine issue of material fact through mere speculation or the building of one inference upon another.” Harlevsville Mut. Ins. Co. v. Packer, 60 F.3d 1116, 1120 (4th Cir. 1995) (citing Beale v. Hardy, 769 F.2d 213,214 (4th Cir.1985)).

DISCUSSION

In determining whether CIT gained possession of the Lottery Ticket Proceeds in breach of a trust existing between the Debtor and the Louisiana Lottery, the court must first determine whether a trust existed. A trust requires three basic elements: (1) identification of trust property known as the res; (2) a fiduciary relationship between a trustee and a beneficiary requiring the trustee to deal with the trust res for the benefit of the beneficiary; and (3) the **manifestation** of an intent to create a trust. See Restatement {Second}, Trusts § 2. The Louisiana Lottery Act provides as follows:

- (1) All proceeds from the sale of lottery tickets received by a lottery retailer shall constitute a trust fund until paid to the corporation either directly or through the corporation’s authorized collection representative. A lottery retailer shall have a fiduciary duty to **preserve** and account for lottery proceeds and lottery retailers shall be personally liable for all proceeds. Proceeds shall include unsold instant tickets received by a lottery retailer and cash proceeds of sale of any lottery products, net of allowable sales commissions and credit for lottery prizes to winners by lottery retailers. Sales proceeds and unused instant **tickets** shall be delivered to the corporation or its authorized collection representative upon demand,
- (2) The corporation shall, by administrative regulation, require retailers to

place all lottery proceeds due the corporation in accounts in institutions insured by the Federal Deposit Insurance Corporation not later than the close of the next banking day after the date of their collection by the retailer until the date they are paid over to the corporation. The corporation may require a retailer to establish a single separate electronic funds transfer account, where available, for the purpose of receiving monies from ticket sales, **making** payments to the corporation, and receiving payments from the corporation. Unless otherwise authorized in writing by the corporation, each lottery retailer shall establish a separate bank account for lottery proceeds which shall be kept separate and apart from all other funds and assets and shall not be commingled with any other funds or assets.

La. Rev. Statute 47:9055. In addition to these statutory provisions, each lottery retailer enters into a contract in which it agrees to the terms and conditions as set forth in the Louisiana Lottery Act.

In this case, all of the essential elements of a trust are present. The specific terms of the statute identify the property of the trust, or the res, as the proceeds **from** the sale of lottery tickets received by a lottery retailer. The statute **further** provides that these proceeds constitute a trust fund until paid to the Louisiana Lottery. It manifests a clear intent to create a trust, and provides for a fiduciary relationship between the lottery retailer and the Louisiana Lottery. The Debtor agreed to operate in a manner consistent with the Louisiana Lottery Act by entering into the Lottery Contract. Based upon this clear statutory language and the language of the Lottery Contract, the **court** finds that all proceeds received by the Debtor from the sale of lottery tickets were held in statutory trust for the Louisiana Lottery.

The evidence presented establishes that all proceeds received by the Debtor from the sale of lottery tickets were deposited into individual store accounts, transferred to the consolidated account, and swept daily by CIT. The Financing Agreement between CIT and the Debtor provides for strict control of the funds collected by each individual Company. Section 3.4 of the

Financing Agreement provides:

Any checks, cash, notes or **other** instruments or property received by any Company with respect to any Accounts or sale of any Inventory shall be held by such Company in trust for the **Agent**, separate **from** such Company's own property and funds, and immediately deposited in blocked accounts approved by the Agent ... over which the Agent, by express written agreements with the Companies and the banks at which the blocked accounts are established ... shall have sole and exclusive withdrawal authority.

The definition of "Accounts" as set forth in the Financing Agreement includes all of each Company's now existing and future accounts as defined in the U.C.C. The definition of "Inventory" as set forth in the Financing Agreement includes all of each Company's present and hereafter acquired inventory as defined in the U.C.C. including, without limitation all merchandise, inventory and goods, and all additions, substitutions and replacements thereof.

The parties do not dispute that the Debtor complied with this term of the Financing Agreement. **Therefore**, when the Debtor sold lottery tickets and deposited the proceeds into its local store accounts, the Debtor was required by the Financing Agreement to transfer those funds, into blocked accounts. Once deposited in the blocked account, CIT had complete control over the funds. All funds deposited into **the** blocked account, including the specific Lottery Ticket Proceeds at issue in this action, were applied by CIT to the Debtor's loan balance.* The Court **finds** that the Louisiana Lottery has met its initial burden of proof in that it has presented evidence of the existence of a trust and the receipt of trust assets by CIT. Consequently, CIT must come forward with some evidence that creates a genuine issue of material fact as to the

¹ In the ordinary course of business, CIT would have funded the Debtor's operating account after applying any swept funds to the Debtor's loan balance. As stated previously, just prior to the Petition Date, CIT ceased funding **the** Debtor's operating account.

existence of the trust, the breach thereof, or an affirmative defense.

CIT denies any liability to the Louisiana Lottery and advances four arguments in defense of the Louisiana Lottery's motion and in support of its own motion for summary judgment seeking to dismiss the complaint. CIT contends that (1) the Louisiana Lottery is equitably estopped from asserting the existence of a trust since it knowingly operated in **violation** of the law which purports to create the trust; (2) if the trust was breached, the Louisiana Lottery consented to the breach; (3) the trust was never breach because is operated exactly the way established by the parties court of conduct; or (4) if the trust was breached, CIT is a bona fide purchaser. The court will address each of these arguments in turn.

First, CIT contends that, despite the clear statutory language of the Louisiana Lottery Act, the Louisiana Lottery should be equitably estopped from asserting the existence of the trust since it knowingly operated in violation of the Louisiana law which creates the trust. The doctrine of equitable estoppel precludes a party from asserting rights he otherwise would have had against another when his own conduct renders assertion of those rights contrary to equity. Hawkoere Shipping Co., Ltd. v. Intamex, S.A., 330 F.3d 225, 238-39 (4th Cir. 2003) citing Int'l Paper Co. v. Schwabedissen Maschinen, 206 F.3d 411, 417-18 (4th Cir.2000). Estoppel is an affirmative defense and the burden of proof is on the person asserting it. F.D.I.C. v. Duffy, 47 F.3d 146, 150 (5th Cir. 1995); Banks v. C.I.R., 345 F.3d 373,387 (6th Cir. 2003).

CIT claims that the Louisiana Lottery has admitted that it routinely acts contrary to the express requirements of the applicable **statute** with regard to the segregation of lottery ticket proceeds. CIT has not produced evidence to support such a claim. The evidence presented to the court establishes that the Louisiana Lottery required that the Debtor establish a separate

account from which lottery ticket proceeds would be swept. From the Louisiana Lottery's point of view, Debtor complied with both the **statute** and the Lottery Contract, The funds were indeed swept on a weekly basis from a segregated lottery account. The Louisiana Lottery had no reason to question the Debtor or otherwise **suspect** that something was amiss. The **testimony** of the Louisiana Lottery's representative. indicates that the Louisiana Lottery was not involved in how the Debtor got lottery ticket proceeds into the account or in any other aspects of the Debtor's management of the business. The Louisiana Lottery's representative testified that the Louisiana Lottery was not aware of the bank account activity that the Debtor was using prior to the bankruptcy filing.

Based upon the evidence submitted, the court determines that CIT has not met its burden of proving, under applicable **summary** judgment standards, that the Louisiana Lottery's cause of action should be barred by this equitable doctrine. CIT failed to produce evidence that creates an issue of material fact as to whether the Louisiana Lottery knowingly operated in violation of the Louisiana Lottery Act. Speculation does not fulfill CIT's burden of producing some evidence to support its defense to the Louisiana Lottery's **summary** judgment motion. Therefore, the court **finds** that the doctrine of equitable **estoppel** is not **applicable** in this case and the Louisiana Lottery is not estopped **from** asserting that the Lottery Ticket Proceeds were held in trust.

In a related argument, CIT contends that, despite the existence of a statutory trust, the Louisiana Lottery consented to the breach of such trust, CIT bases this argument on the assertion that the Louisiana Lottery had knowledge that the Debtor was not immediately placing the lottery proceeds into the segregated lottery account, but, rather, was **using** those proceeds to pay the Debtor's debt to CIT. Again, CIT had produced no **evidence to** support **this** claim, **only**

speculative allegations. Again, the evidence submitted by the parties clearly establishes that the Louisiana Lottery was **not** involved in the cash management system of the Debtor, **and** was only aware of the existence of a separate lottery account, from which it could sweep lottery proceeds on a weekly basis. The court can not find that the Louisiana Lottery's failure to investigate the Debtor's cash management system amounts to consent to the breach of trust as a matter of law, **particularly** in light of the Lottery Contract, which required the Debtor to abide by the statutory provisions of the Louisiana Lottery Act.

The third defense submitted **by** CIT in response to the Louisiana Lottery's claim to recover proceeds **taken in** breach of trust is that the trust was never breached. CIT contends that the trust actually operated in exactly the way established by the course of dealings between the Louisiana Lottery and the Debtor, because **the written** requirements of the statutory trust were waived. Pursuant to the parties' course of dealings, the lottery proceeds were swept into the CIT concentration account for application to the Debtor's outstanding obligations under the Financing Agreement. The lottery account was then funded by the Debtor from its operating account. CIT contends **that** this funding procedure was used by the Debtor with the acquiescence and encouragement of the Louisiana Lottery. Thus, when **CIT** ceased advancing funds to the Debtor and the Debtor failed to fund the lottery account in October 2002, these actions were consistent **with the way** that the trust was designed to **operate** pursuant to the parties' course of conduct. Therefore, there was no breach of trust and there is no basis for holding CIT liable for the Louisiana Lottery's loss.

CIT relies upon In re Valle Otero, 174 B.R. 873 (Bark. D. P.R. 1994), for the proposition that statutory trusts **and** the fiduciary obligations arising from that trust may be

waived by the parties' course of conduct which is contrary to or inconsistent with the fiduciary relationship. Id. at 88 1. Waiver is the "intentional relinquishment of a known right, power, or privilege." F.D.I.C. v. Duffy, 47 F.3d at 150. A finding of waiver is only appropriate upon a showing that the beneficiary of the trust had actual knowledge of conduct which was contrary to the terms of the contract and statutory fiduciary obligations. In re Valle Otero, 174 B.R. at 881. The burden of proof rests on the party claiming waiver, and courts are reluctant to presume that valuable rights have been waived in the absence of clear evidence to the contrary. U.S. v. Stout, 415 F.2d 1190, 1192 -1193 (4th Cir. 1969); F.D.I.C. v. Duffy, 47 F.3d at 150.

In this case, the evidence indicates that the Louisiana Lottery had no actual knowledge of conduct by the Debtor which was contrary to the terms of its statutory obligations. CIT has failed to offer any nonspeculative evidence demonstrating that there was a genuine dispute as to this particular fact. Therefore, the court **finds** that the doctrine of waiver is not applicable in this case and will not look to course of conduct as a source of evidence regarding the Debtor's duties as trustee or the way the trust was designed to operate.

Because the court has found that the Louisiana Lottery Act creates a statutory trust for proceeds from the sale of lottery tickets and that no waiver, consent or change of trust terms occurred based on the course of conduct between the parties, the court **finds** that the Lottery Ticket Proceeds **were** subject to a statutory **trust** when transferred into the consolidated blocked account. The issue then becomes whether the trust was destroyed when the Debtor transferred trust property into an account with other funds. While the trust funds were commingled with **nontrust** funds, this fact alone does not destroy the trust, A party claiming entitlement to a trust must be able to trace trust assets to the property it claims is subject to the trust. In re Dameron,

155 F.3d 718 (4th Cir. 1998). Tracing is an issue of federal law. Id., at 723. When trust funds are commingled, if the amount on deposit has at all times equaled or exceeded the amount of the trust, the trust remains intact. Id., at 724. This principle is generally referred to as the “lowest intermediate balance” rule.

CIT does not dispute that the Lottery Ticket Proceeds were deposited into the Debtors accounts and then transferred to a concentration account. There is no allegation that the Debtor somehow diverted or spent the trust funds prior to the *time* that CIT swept the concentration account. In fact, pursuant to the Financing Agreement, all cash was required to flow through CIT. The Debtor was not permitted to net expenses or otherwise reduce **the** amount swept by CIT by **the** amount it needed to make payments to creditors, such as vendors, employees, or the Louisiana Lottery. Therefore, it was not possible for the amount on deposit in the Debtor’s account to fall below **the** amount of **the** trust prior to the time that the money was taken by CIT. It follows, then, that the funds CIT swept from the Debtor’s concentration account included the Lottery Ticket Proceeds which were subject to a statutory trust.

CIT’s final argument is that, if a trust did exist, CIT is still entitled to retain the Lottery Ticket Proceeds **free** of any trust as a bona fide purchaser. As a general rule, when a trustee transfers trust property to a third person in breach of his or her **fiduciary** duty to the beneficiaries, the third person takes the property subject to the trust, unless that third person has purchased the property for value and **without** notice of the fiduciary’s breach of duty. Harris Trust and Sav. Bank v. Salomon Smith Barney, Inc., 530 U.S. 238,250, 120 S.Ct. 2180, 2189 (2000). CIT contends that it is entitled to retain the Lottery Ticket Proceeds free of any trust because it was a bona fide **purchaser** of the **Lottery Ticket** Proceeds, as that term is used in the

Restatement (Second) of Trusts. The bona fide purchaser defense is defined by the Restatement (Second) of Trusts § 284 as follows:

(1) If the trustee in breach of trust transfers trust property to, or creates a legal interest in the subject matter of the trust in, a person who takes for value and without notice of the breach of trust, and who is not knowingly taking part in an illegal transaction, the latter holds the interest so transferred or created **free** of the trust, and is under no liability to the beneficiary. (2) In the Restatement of this Subject such a transferee is called a “bona fide purchaser.”

In establishing the protected status of bona fide purchaser, the burden of proof is on the transferee. Albee Tomato, Inc. v. A.B. Shalom Produce Corp., 155 F.3d 412,616 (2nd Cir. 1998); Oscar Gruss & Son v. First State Bank, 582 F.2d 424,432 (7th Cir.1978). To establish that CIT was a bona fide purchaser, CIT must show that it gave value for the Lottery Ticket Proceeds and that it took the Lottery Ticket Proceeds without notice of a breach of trust.

While there is no evidence that CIT had actual notice of the breach of trust, **under** general principles of trust law, a transferee has the requisite constructive knowledge when it “knows or should *know* of the breach of trust.” Restatement (Second) of Trusts § 297 (emphasis added). A transferee should know of a breach of trust when it knows facts which under the circumstances would lead a reasonably intelligent and diligent person to inquire whether the trustee is committing a breach of trust, and if such inquiry when pursued with reasonable intelligence and diligence would give it knowledge or reason to **know** that there is a breach of trust. Albee Tomato, Inc. v. A.B. Shalom Produce Corp., 155 F.3d at 616. Under such circumstances, a transferee may be charged with constructive notice.

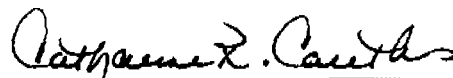
In this case, a genuine issue of material fact exists as to whether **CIT** had constructive notice of a breach of trust. The evidence presented indicates that CIT knew that the Debtor was

in the business of operating convenience stores. A representative of CIT testified that CIT was aware that the Debtor's convenience stores were in the business of selling lottery tickets in those states that operated a lottery, and that CIT considered the lottery tickets part of its collateral. CIT was also aware that the proceeds from the sale of lottery tickets flowed into CIT's accounts. These facts could support a conclusion that CIT had constructive notice because a reasonably diligent person might inquire as to the existence of a trust and whether transfers were being made in breach of that trust. These facts raise a genuine issue of material fact as to constructive notice, precluding summary judgment in favor of CIT as a bona fide purchaser.

Lastly, the court will address the issue of the Unsettled Lottery Ticket Proceeds in the amount of \$107,192.78. The court finds that there are numerous material facts in dispute, including whether these funds were ever deposited into the Debtor's consolidated account and applied to CIT loans. At the hearing *on* this matter, counsel for the Louisiana Lottery was unable to explain, to the satisfaction of this court, whether the sum of \$107,192.78 represents a credit, or actual funds that were collected by the Debtor. No evidence was presented by the Louisiana Lottery to clarify this issue. Nevertheless, CIT has not demonstrated that, as a matter of law, the Louisiana Lottery will not be able to show that the Unsettled Lottery Ticket Proceeds were not a part of the statutory trust. The court concludes that neither party is entitled to summary judgment as to the Unsettled Lottery Ticket Proceeds. The parties must proceed to trial for an evidentiary hearing on this claim.

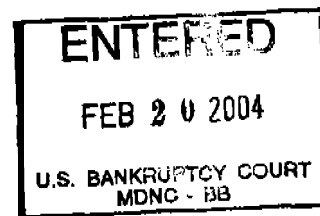
Therefore, based on the foregoing, an Order will be entered contemporaneously with the entry of this Memorandum Opinion denying the motions for summary judgment.

This the ~~24~~²⁵ of February 2004.



Catharine R. Carruthers
Catharine R. Carruthers
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
DURHAM DIVISION



In re:)
)
E-Z Serve Convenience Stores,) **Case No. 02-83 138**
Inc., et al.,)
)
Debtors)


_____)
Louisiana Lottery Corporation)
)
v.) **Ad. Proc. No. 03-9018**
)

CIT Group Business Credit, Inc., and)
E-Z Serve Convenience Stores, Inc.,)
thru its Trustee, Richard **Hutson**)
_____)

ORDER DENYING CROSS MOTIONS
FOR SUMMARY JUDGMENT

Pursuant to the Memorandum Opinion **filed** contemporaneously herewith, it is **hereby**
ORDERED that the Louisiana Lottery's Motion for Summary Judgment and **CIT's** Cross Motion
for Summary Judgment are both DENIED.

This the 20th day of February 2004.



Catharine R. Carruthers
United States Bankruptcy Judge