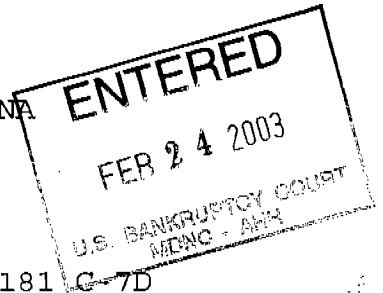


IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE MIDDLE DISTRICT OF NORTH CAROLINA  
DURHAM DIVISION



IN RE: )  
 )  
Herbert H. Hearne, ) Case No. B-02-81181 C-7D  
 )  
Debtor. )

ORDER

This case came before the court on January 30, 2003, for hearing upon a motion filed by General Motors Acceptance Corporation ("GMAC") to require the Trustee in this case to turnover to GMAC the proceeds of an insurance check that was held by the Debtor when this Chapter 7 case was filed and turned over to the Trustee by the Debtor. Pamela P. Keenan appeared on behalf of GMAC and Sara A. Conti appeared on behalf of the Trustee.

FACTS

The following facts are not in dispute. On February 21, 2001, the Debtor and Thompson-Hearne Investment, Inc. entered into a GMAC SmartLease Agreement ("the Lease"), pursuant to which the Debtor agreed to lease a 2001 Cadillac Deville from GMAC for a period of 36 months at the rate of \$953.43 per month. The 2001 Cadillac covered by the Lease was titled in the name of GMAC and had a value of \$50,567.00 when the Lease was executed. On April 2, 2002, the Debtor was involved in an accident while driving the 2001 Cadillac which was not the fault of the Debtor. On April 10, 2002, a check in the amount of \$4,921.72 was issued by the insurance company for the other driver involved in the accident. The check was made

payable solely to the Debtor and was issued in settlement of the claim for repair of the physical damage to the Cadillac. On April 19, 2002, while the insurance check remained in the possession of the Debtor, an involuntary chapter 7 petition was filed against the Debtor. Upon an order for relief being entered and the Trustee being appointed on May 14, 2002, the Debtor turned the insurance check over to the Trustee, who deposited the check in her trust account where the funds remain on deposit. The Debtor also returned the Cadillac to GMAC shortly after the filing of this case without the damage to the Cadillac having been repaired.

#### ANALYSIS

GMAC contends that the Debtor had only legal title to the funds represented by the insurance check and that GMAC is entitled to recover the proceeds from the Trustee based upon § 541(d) of the Bankruptcy Code.<sup>1</sup> GMAC argues that the Debtor held the funds subject to a trust for GMAC and therefore had no equitable interest in the funds. Although the funds became property of the bankruptcy estate as a result of Debtor holding legal title to the funds, the

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<sup>1</sup>Section 541(d) provides:

(d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate under subsection (a) (1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

court has concluded that GMAC nevertheless is entitled to recover the funds from the Trustee because under applicable law, the Debtor held the funds in trust for GMAC.

- A. The insurance proceeds became property of the bankruptcy estate to the extent of Debtor's legal title

Section 541 of the Bankruptcy Code contains a broad definition of what constitutes "property of the estate." Under subsection (a)(1) of § 541, property of the estate includes all legal or equitable interests of the debtor in property as of the commencement of the case, except as provided in subsections (b) and (c)(2). This broad definition brings into the bankruptcy estate property which is held by the debtor as a trustee, since the debtor holds legal title to such property. However, subsection (d) of § 541 provides that property in which the debtor holds only legal title and not an equitable interest, becomes property of the estate under § 541 only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold. Read as a whole, § 541 means that the bankruptcy court acquires jurisdiction over property held in trust by the debtor at the commencement of the case and the court has jurisdiction to enter dispositive orders with respect to such property, but such orders are circumscribed by the limitation contained in subsection (d). See In re Johnson, 960 F.2d 396, 399 (4th Cir. 1992). The result in the present case is that this court

has jurisdiction over the funds and authority to enter a dispositive order regarding the funds.

B. Effect of § 541(d) upon entitlement to funds

As a general rule, the effect of subsection (d) of § 541 is that trust beneficiaries are entitled to the trust property to the exclusion of creditors or other claimants in the bankruptcy case. "Therefore when the debtor is in possession of property impressed with an express, constructive, resulting or statutory trust whose validity is recognized under the terms of the Code, the estate will generally hold such property subject to the outstanding interest of the beneficiaries." COLLIER ON BANKRUPTCY § 541.11[5], p. 541-68 (15th ed. rev. 2001). See also In re Marrs-Winn Co., Inc., 103 F.3d 584, 590 (7th Cir. 1996) ("trust proceeds can only be distributed to trust beneficiaries, and not to the creditors of the bankruptcy estate"); American Service Co. v. Henderson, 120 F.2d 525, 529 (4th Cir. 1941) ("where the debtor had been in the possession of trust property, the bankruptcy or reorganization trustee holds such property subject to the outstanding interest of the beneficiaries").

A party seeking to recover assets or funds from the bankruptcy estate on the theory that the assets or funds are subject to a trust has the burden of proof. See In re Johnson, 960 F.2d at 401; Sonnenschein v. Reliance Ins. Co., 353 F.2d 935 (2d Cir. 1965). Two showings are required in order to carry the burden of proof:

(1) the claimant must demonstrate that a trust exists; and (2) the claimant must identify the asset or fund subject to the trust and show that it is in the possession of the trustee. See Goldberg v. New Jersey Lawyers' Fund for Client Protection, 932 F.2d 273, 281 (3rd Cir. 1991). Since it is undisputed that the Trustee holds the proceeds from the insurance check in her trust account, the only showing required of GMAC in the present case is a showing that the funds are subject to some form of valid trust.<sup>2</sup>

C. Applicable law in determining whether trust exists.

Whether the funds represented by the insurance check are subject to a trust is a matter involving the property rights of the contesting parties. Determination of such a matter by the bankruptcy court is controlled by state law in the absence of an overarching federal interest. See Butner v. United States, 440 U.S. 48, 54, 99 S.Ct. 914, 917-18, 59 L.Ed.2d 136 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an

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<sup>2</sup>If the trust property consist of funds that have been commingled then the claimant has the additional burden of tracing the funds in order to satisfy the requirement that the trust property be identified. "There can be no recovery . . . where all that can be shown is enrichment of the trustee. [The trust property] must be clearly traced and identified in specific property." In re Dameron, 155 F.3d 718, 723 (4th Cir. 1998). In accord In re Columbia Gas Systems, Inc., 997 F.2d 1039, 1063 (3rd Cir. 1993); In re Johnson, 960 F.2d at 401; American Service Co. v. Henderson, 120 F.2d at 529.

an interested party is involved in a bankruptcy proceeding."). This principle is applicable where the bankruptcy court is called upon to determine whether property held by a bankrupt is subject to a trust and state law therefore is controlling. See In re Dameron, 155 F.3d 718, 722 (4th Cir. 1998) ("Our consideration of what constitutes an 'equitable interest' subject to exclusion from the bankruptcy estate under § 541(d) is a question of state law."); In re B.I. Financial Services Group, Inc., 854 F.2d 351 (9th Cir. 1988); In re General Coffee Corp., 828 F.2d 699 (11th Cir. 1987); In re N.S. Garrott & Sons, 772 F.2d 462 (8th Cir. 1985). But see In re Columbia Gas Systems, Inc., 997 F.2d 1039, 1059 (3d Cir. 1993); In re Edison Bros., Inc., 243 B.R. 231, 236 (Bankr. D. Del. 2000). In this case, which is pending in a bankruptcy court sitting in North Carolina, involving a North Carolina debtor and transactions that occurred entirely within North Carolina, the applicable law is North Carolina law.

D. Applicable North Carolina law

The long standing rule in North Carolina law is that a bailee, such as a lessee of personal property, has standing to sue or settle with a tortfeasor for the full amount of the damage to the property that is the subject of the bailment or lease. See Frockt v. Goodloe, 670 F. Supp. 163, 166 (W.D.N.C. 1987) (applying North Carolina law). However, to the extent that the recovery by the bailee exceeds his special interest and includes funds that should

go to the bailor, such excess funds are held by the bailee in trust for the bailor. See American Surety Co. v. Baker, 172 F.2d 689, 690-91 (4th Cir. 1949) (under law of North Carolina it is generally held that the bailee can recover full damages for the loss or injury to the bailed property but such bailee holds the excess beyond his own interest in trust for the bailor); Hopkins v. Colonial Stores, Inc., 224 N.C. 137, 139, 29 S.E.2d 455, 457 (1944); Harris v. Seaboard Air Line Ry. Co., 190 N.C. 480, 130 S.E. 319, 321 (1925); Asheville & E.T.R. Co. v. Baird, 164 N.C. 253, 80 S.E. 406, 407 (1913) (holding that the rule with respect to the right of action in the mortgagee or mortgagor is the same as in the case of bailor and bailee, with the result that "[w]hen the mortgagor has received payment for the damages, he holds the same in trust for his mortgagee who may enforce the trust by appropriate proceedings."). Although the parties may alter this rule by their agreement, it is clear that the parties in the present case did not do so. Thus, while the Lease recognized the standing of the Lessee to settle a claim for damage to the Cadillac, Paragraph 23 of the Lease specifically provides that should the Cadillac be damaged and the Debtor receive money from insurance or a settlement, GMAC "will be entitled to this money." As the bailee of the Cadillac, the Debtor had standing to settle the claim arising from the damage to the vehicle. However, the settlement was intended to include the cost of repairing the damage to the Cadillac and, upon receipt of

the settlement check, the Debtor held the check in trust for GMAC to the extent that funds represented by the check were required to pay for the repairs to the Cadillac. Since it apparently is undisputed that the cost incurred by GMAC in repairing the damage was \$4,921.72, it follows that GMAC is entitled to recover the entire \$4,921.72 of proceeds held by the Trustee.

IT IS SO ORDERED.

This 21<sup>st</sup> day of February, 2003.

**William L. Stocks**

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WILLIAM L. STOCKS  
United States Bankruptcy Judge