No. 14-1098

In the Supreme Court of the United States

MICHAEL G. WOLFF, TRUSTEE, PETITIONER

v.

UNITED STATES OF AMERICA, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the trustee of a bankrupt payroll company may avoid payments made by the company from funds held in an express trust for its clients and paid to the IRS to satisfy the clients' tax obligations.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-25a) is reported at 773 F.3d 583. The order of the district court (Pet. App. 26a-27a) is unreported. The opinion of the bankruptcy court (Pet. App. 40a-66a) is unreported but is available at 2012 WL 3778952. A prior opinion of the court of appeals is not published in the *Federal Reporter* but is reprinted at 391 Fed. Appx. 259.

JURISDICTION

The judgment of the court of appeals was entered on December 12, 2014. The petition for a writ of certiorari was filed on March 11, 2015. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. "Equality of distribution among creditors is a central policy of the Bankruptcy Code." *Begier* v. *IRS*, 496 U.S. 53, 58 (1990). In order to ensure that the debtor's property is divided equitably, a bankruptcy trustee may avoid certain preferential, prepetition transfers of the debtor's property. 11 U.S.C. 547(b). Section 547 generally permits the trustee to avoid "any transfer of an interest of the debtor in property" made within the 90-day period preceding the bankruptcy petition if the transfer would have enabled the creditor to receive more than its fair share of the estate. *Ibid.* "The reach of § 547(b)'s avoidance power is therefore limited to transfers of 'property of the debtor.'" *Begier*, 496 U.S. at 58.

Section 547 is designed to recover only "property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings." *Begier*, 496 U.S. at 58. The scope of "property of the estate," 11 U.S.C. 541, thus determines what property is recoverable under Section 547. The bankruptcy trustee bears the burden to demonstrate that the requirements for avoidance have been met. 11 U.S.C. 547(g).

The Bankruptcy Code defines the bankruptcy estate to include "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case." 11 U.S.C. 541(a)(1). When a debtor holds "only legal title and not an equitable interest" in property, however, the property "becomes property of the estate * * * 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." 11 U.S.C. 541(d). Because a debtor "does not own an equitable interest in property he holds in trust for another, that interest is not 'property of the estate.'" *Begier*, 496 U.S. at 59 (citation omitted).

2. This case concerns the ownership of funds that the debtor, a payroll-services company named FirstPay, Inc., transferred to the IRS on behalf of its clients. Each client signed a "Services Agreement" under which FirstPay would withdraw funds—enough to cover employee wages, taxes, and a small service fee—from the client's checking account. Pet. App. 4a. The amounts collected were deposited into a FirstPay account called the "tax account." *Ibid.* FirstPay agreed to hold the tax funds until they were due and then submit them to the appropriate taxing authorities. *Ibid.* In the 90 days preceding bankruptcy, FirstPay transferred nearly $28 million from the tax account to the IRS. *Id.* at 6a.

Not all of the client funds credited to the FirstPay tax account, however, were actually transferred in accordance with the client contracts. Pet. App. 4a. FirstPay transferred some of the funds to its general operating account to pay its own business expenses, and transferred other funds to another account to support the "lavish" lifestyles of its principals. *Ibid.* FirstPay ultimately failed to pay the IRS more than $5 million that its clients owed in taxes. *Id.* at 45a.

3. Creditors forced FirstPay into involuntary bankruptcy, and petitioner, as the appointed trustee, filed an adversary complaint against the United States seeking to recover payments made by FirstPay to the IRS on behalf of its clients. Pet. App. 5a-6a. After various proceedings in the bankruptcy court, district court, and court of appeals, see *id.* at 6a-7a, a single

issue remained: whether the $28 million that FirstPay had paid to the IRS during the 90 days preceding FirstPay's bankruptcy was a "transfer of an interest of the debtor in property," 11 U.S.C. 547(b), and therefore avoidable by the trustee. Pet. App. 7a-8a.[1]

a. On cross-motions for summary judgment, the bankruptcy court held that FirstPay was "only a delivery vehicle for the payments it made to the IRS, lacking any equitable interest in the funds entrusted to it." Pet. App. 59a. The court explained that FirstPay's "express task on behalf of its clients was to calculate the sums due the governmental agencies and transmit the funds thereto"; that "under the attendant circumstances the intention to create a trust as to the funds is irrefutable"; and that "[a]s such, said funds were not 'property of the debtor' for purposes of § 547(b)." *Ibid.* (citing *Begier*, 496 U.S. at 59).

The district court affirmed. Pet. App. 28a-39a. The court relied on the parties' "clear intention" that client funds should be paid "directly to the government" and "should not ever become property of the debtor." *Id.* at 35a. The court also rejected petitioner's argument that the client funds were presumptively FirstPay's unless the government could trace the funds the IRS received to the particular client on whose behalf the payment was made. *Id.* at 37a-38a.

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[1] The question presented in the petition for a writ of certiorari concerns only the proper treatment of the funds that FirstPay actually transferred to the IRS in accordance with its client agreements. "Funds withdrawn from the tax account and moved either to the 'operating account' to pay FirstPay's operating expenses or to the 'exchange and reimbursement account' to be squandered by FirstPay's principals are not at issue." Pet. App. 19a n.6.

b. The court of appeals affirmed. Pet. App. 1a-27a. The court held that the client contracts had created under Maryland law an express trust under which FirstPay was "obligated to handle the tax funds solely for the benefit of its clients and of the taxing authorities in satisfaction of the clients' tax obligations." *Id.* at 13a. As a consequence, "the tax funds received and transferred by FirstPay pursuant to its obligations under the Services Agreement were trust property in which FirstPay held no equitable interest." *Ibid.*

The court of appeals rejected petitioner's argument that "the funds FirstPay ultimately transferred to the IRS cannot be deemed trust property because they had been commingled with other funds and therefore cannot be effectively identified or traced." Pet. App. 15a. Under Maryland law, "[a] beneficiary's entitlement to a trust fund fails for insufficiency of identification 'where it appears that the trust fund has been dissipated or so mingled and merged with the general assets of the insolvent estate as not to be separable or distinguishable therefrom.'" *Id.* at 18a (quoting *Frederick Cnty. Comm'rs* v. *Page*, 164 A. 182, 191 (Md. 1933)). The funds at issue in this case, however, "were not 'mingled and merged' with FirstPay's general assets or 'dissipated' but, rather, were received from FirstPay's clients, held in the tax account, and then transferred to the IRS as intended." *Id.* at 19a. Accordingly, the funds remained in the trust and never became FirstPay's property. See *ibid.* ("These tax funds can thus be traced and connected to the trust.").

The court of appeals explained that its conclusion was supported by *Begier*, *supra*, which involved "an analogous situation" in which client funds paid to the IRS from the debtor's general operating accounts were claimed as property of the debtor. Pet. App. 19a. To determine ownership of the funds, the Supreme Court in *Begier* applied "'reasonable assumptions' [about] whether particular funds in the debtor's possession [we]re tax funds held in trust for the Government." *Id.* at 20a (quoting 496 U.S. at 65). In this case, the court of appeals explained, "reasonable assumptions" would lead "a court [to] presume that funds received, held, and conveyed by a trustee in accordance with the purpose and for the benefit of a trust, although commingled with funds not subject to that trust, are indeed funds subject to the trust." *Id.* at 21a; see *ibid.* ("This position comports with both the Maryland law of trusts and the Bankruptcy Code."). Because petitioner had failed to rebut that presumption—*i.e.*, had failed to show that the funds were "FirstPay's own property and not the tax funds it held in trust for the benefit of its clients and the Government"—the court rejected petitioner's attempt to recover the funds. *Id.* at 22a.

ARGUMENT

The court of appeals correctly determined that FirstPay lacked an equitable interest in funds held in an express trust for its clients' benefit and transferred to the IRS on its clients' behalf. The transfers therefore were not "of an interest *of the debtor* in property," as Section 547(b) requires. Petitioner contends that FirstPay's transfers are avoidable unless each payment can be traced to the particular client on whose behalf the payment was made. Petitioner does not dispute, however, that all the payments at issue were of funds held in trust for *some* client. Petitioner therefore cannot show, as it must, that any of the disputed funds belonged to FirstPay.

Petitioner has not identified any court of appeals decision that is inconsistent with the ruling below. Instead, petitioner attempts to analogize this dispute to cases in which funds held in trust by a debtor were commingled with the debtor's *own* funds. Petitioner points to no case in which tracing was required even though the debtor had not claimed ownership of the disputed funds. Further review is not warranted.

1. Section 547 permits a trustee to avoid certain "transfer[s] of an interest *of the debtor* in property." 11 U.S.C. 547(b) (emphasis added). "The reach of § 547(b)'s avoidance power is therefore limited to transfers of 'property of the debtor'"—that is, property in which the debtor has an equitable interest. *Begier* v. *IRS*, 496 U.S. 53, 58 (1990). The court of appeals concluded, and petitioner does not here deny (Pet. 11), that FirstPay had no equitable interest in the disputed funds, which FirstPay held in an express trust under Maryland law for the purpose of submitting them to the appropriate taxing authorities. Pet. App. 13a. Because the funds were "transferred [to the IRS] by FirstPay pursuant to its obligations under" the trust agreements, they were "trust property in which FirstPay held no equitable interest." *Ibid.* Under settled principles, that was sufficient to render Section 547(b) inapplicable. See *Begier*, 496 U.S. at 59 ("Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not * * * 'property of the debtor' for purposes of § 547(b).").

Petitioner argues that the decision below "nullified the long-established principle of federal law that * * * the party alleging that it received common-law trust property bears the burden of tracing the funds it received to the *res* of a particular customer's common-law trust." Pet. 14-15 (dash omitted). Because the funds taken from FirstPay's clients were combined into a single account, and all payments made to the IRS came from that account, "there is no way to determine whether a payment to the IRS for the benefit of one customer was made with another customer's funds." Pet. 10. The inability to trace specific payments to specific clients, petitioner argues, means that all "the payments of such funds are avoidable and must be distributed ratably among FirstPay's defrauded creditors." Pet. 20. Petitioner's argument is flawed in multiple respects.

First, it is *petitioner*, as the party seeking avoidance, who "has the burden of proving the avoidability of [the] transfer[s]" at issue. 11 U.S.C. 547(g). Petitioner refers to the principle that an "entity seeking to exclude the property from the estate" bears the burden of tracing funds "[w]hen property *in the possession of a debtor* is alleged to be held in trust by the debtor for a nondebtor." Pet. 18 (quoting 5 *Collier on Bankruptcy* ¶ 541.28 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2014)) (emphasis altered); see Pet. 16 (explaining that traceability is required to exclude "assets [that] went into the hands of the trustee *and remained there until the time of his insolvency*") (quoting George Gleason Bogert & George Taylor Bogert, *The Law of Trusts and Trustees* § 923 (rev. 2d ed. 1995)) (emphasis added; ellipsis omitted). The funds at issue here were not in FirstPay's possession at the time of the bankruptcy, and the government is not seeking relief. Instead, petitioner seeks to recover, through a claim for avoidance, funds that were transferred to the IRS during the 90-day period *before*

FirstPay filed for bankruptcy. Pet. App. 5a-6a. See *id.* at 19a n.6 (funds moved into FirstPay's operating and reimbursement accounts "are not at issue"). Under the statute's plain text, petitioner "has the burden" of substantiating that claim. 11 U.S.C. 547(g).

Second, the issue of traceability is simply a red herring here. The need to trace funds arises when two or more parties lay claim to ownership of the funds—for instance, when a trust beneficiary asserts ownership over trust funds that have been commingled with the trustee's own assets. In such a case, petitioner is correct that tracing may be required to resolve ownership of the funds as between those who lay claim to them. See Pet. 18 (citing 5 *Collier on Bankruptcy* ¶ 541.28). In this case, by contrast, petitioner does not contend that FirstPay itself has any claim to the disputed funds. See, *e.g.*, Pet. 11. Whether any particular FirstPay client can, through tracing, assert an ownership claim that is superior to the claims *of other FirstPay clients* is therefore simply beside the point. Regardless of which client contributed the funds paid to the IRS, the funds do not constitute "an interest of the debtor in property," 11 U.S.C. 547(b), because they never belonged to FirstPay.[2]

[2] Petitioner relies (Pet. 16-17) on cases in which a party seeks to impose a constructive trust as "an equitable remedy" for unjust enrichment. *In re Mississippi Valley Livestock, Inc.*, 745 F.3d 299, 304 (7th Cir. 2014). See *In re Advent Mgmt. Corp.*, 104 F.3d 293, 295 (9th Cir. 1997) ("a remedy for things wrongfully detained or gained") (citation, brackets, and internal quotation marks omitted); *In re Southmark Corp.*, 49 F.3d 1111, 1118 (5th Cir. 1995) ("imposition of a constructive trust is a potent remedy"). Whether a party pursuing such a remedy must trace the funds is irrelevant

For similar reasons, petitioner cannot prevail by showing that the present circumstances do not justify the "relaxed tracing burden" that was applied in *Begier*, *supra*. Pet. 36-37 (capitalization altered). *Begier* addressed the ownership of funds in a statutory trust that was created under the Internal Revenue Code by the payment of excise taxes and the withholding of employee wages. 496 U.S. at 61-62. Because the trust was a creation of statute, the Court found "[c]ommon-law tracing rules" to be "unhelpful," *id.* at 62-63, and instead imposed a looser "nexus" requirement, *id.* at 65-67. Petitioner argues that "*Begier* does not permit a federal court to deviate from the long-established tracing requirement applicable to common-law trusts." Pet. 37. As explained above, however, it is irrelevant whether funds paid to the IRS can be traced back to a particular FirstPay client, regardless of whether the tracing is done under the common law rule or under some other approach. What matters is that FirstPay *itself* cannot claim ownership of the funds, which places them beyond "[t]he reach of § 547(b)'s avoidance power." *Begier*, 496 U.S. at 58.[3]

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here, however, because the disputed funds in this case were held in an express trust and had already been transferred in accordance with the trust's terms when the bankruptcy petition was filed. Pet. App. 13a.

[3] Because tracing is not required here to separate trust property from debtor property, petitioner cannot rely (Pet. 15-16) on the principle that "[i]f * * * the matter of identification [is] in doubt the doubt must be resolved in favor of the Trustee." *Schuyler* v. *Littlefield*, 232 U.S. 707, 713 (1914). Similarly irrelevant is the "presumption," discussed in *Cunningham* v. *Brown*, 265 U.S. 1, 9 (1924), "that a wrongdoing trustee first withdrew his own money from a fund mingled with that of his [trust beneficiary]." See Pet.

2. Petitioner asserts (Pet. 24) that the decision below "creates a circuit-split with the United States Court of Appeals for the Ninth Circuit." Petitioner relies on *In re Hamilton Taft & Co.*, 53 F.3d 285 (9th Cir. 1995), which was vacated when the parties settled, 68 F.3d 337 (9th Cir. 1995). A single vacated decision, which is "not binding precedent," *Garcia de Rincon* v. *Department of Homeland Sec.*, 539 F.3d 1133, 1141 n.4 (9th Cir. 2008), cannot give rise to a conflict warranting this Court's review.

In any event, the decision below is fully consistent with the Ninth Circuit's analysis in *Hamilton Taft*. *Hamilton Taft* involved a payroll company (Taft) that was compensated for its services through "use of [client] funds during the interval between the date it received the funds from its clients and the date it paid the[ir] taxes." 53 F.3d at 287. After Taft was forced into bankruptcy, its trustee sought to avoid prepetition payments made to the IRS on behalf of one of its clients. *Ibid.* The client argued that the payments consisted of funds that had been held in trust, but the court of appeals disagreed, noting that the funds were "transferred to Taft without requiring Taft to segregate those funds and hold them in trust." *Id.* at 288. Taft thus "treated the funds as its own assets" and held the funds "free of trust." *Ibid.* Under those circumstances, the court of appeals concluded that "the funds were property of the debtor," and hence the payments to the IRS were "subject to avoidance" under Section 547(b). *Ibid.*

Although the Ninth Circuit held in *Hamilton Taft* that the payments at issue were subject to avoidance,

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19-23 (arguing that the *Cunningham* presumption does not apply in this case).

the court reached that conclusion based on a circumstance (the payroll company's treatment of the funds as its own assets) that is not present here. The Ninth Circuit recognized that payments are "subject to avoidance" only if they are made from "property of the debtor." 53 F.3d at 288. Because Taft "did not hold the [disputed] funds in trust," but instead treated those funds as its own, the money belonged to Taft and the payments to the IRS were avoidable. *Id.* at 287-288. The other payroll-services cases on which petitioner relies (Pet. 27-32) similarly involved payments made from the payroll company's *own* funds, not from funds held in trust. See *Morin* v. *Frontier Bus. Techs.*, 288 B.R. 663, 665 (W.D.N.Y. 2003) (payroll company (Aapex) "paid the [client's] taxes out of Aapex's own general funds"); *In re Pay + Plus Payroll Adm'rs, Inc.*, 389 B.R. 796, 800 (Bankr. M.D. Fla. 2008) ("[T]he Court cannot determine that the Debtor held the funds in trust for [its client], or that the funds were not property of the Debtor at the time of the transfer."); see also *In re Ameripay, LLC*, No. 09-27794, 2012 WL 246397, at *10 (Bankr. D.N.J. 2012) (denying summary judgment because "the court lacks sufficient information to determine if a trust relationship exists, such that the Transfers were not of property of the estate").

Unlike the debtors in *Hamilton Taft* and the other cases on which petitioner relies, FirstPay had no prepetition ownership stake in the funds used to pay the IRS. Indeed, FirstPay does not dispute that "the tax funds received and transferred by FirstPay pursuant to its obligations under the Services Agreement were trust property in which FirstPay held no equitable interest." Pet. App. 13a. Under those circumstances, the funds were not "property of the debtor," and the payments accordingly were not "subject to avoidance." *Hamilton Taft*, 53 F.3d at 288.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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