

04-5638-bk
In Re: Charles Atwood Flanagan

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term, 2006

(Argued September 14, 2006 Decided: October 9, 2007)

Docket Nos. 04-5638-bk(L), 06-0731-bk(XAP)

In Re: Charles Atwood Flanagan

Cadle Co., D.A.N. Joint Venture, L.P.,

Appellants-Cross-Appellees,

v.

Bonnie C. Mangan, Trustee. Charles Atwood Flanagan,
John C. Flanagan,

Appellees-Cross-Appellants,

U.S. Trustee,

Trustee.

Before:

CARDAMONE, MINER, and STRAUB,
Circuit Judges.

Appellants the Cadle Company and D.A.N. Joint Venture, L.P. appeal from a September 30, 2004 judgment of the United States District Court for the District of Connecticut (Arterton, J.), affirming the July 3, 2003 decisions of the United States Bankruptcy Court for the District of Connecticut (Dabrowski, B.J.), which denied appellants' request for the imposition of a

1 constructive trust over certain securities. Appellee-Cross-
2 Appellant Bonnie C. Mangan, trustee, cross-appeals from the same
3 judgment insofar as it found that a payment of \$99,542.87 made by
4 the debtor Charles Flanagan to appellants was partially protected
5 from avoidance by the earmarking doctrine.
6

7 Affirmed.
8

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10 _____
11 EDWARD C. TAIMAN, Jr., Sabia, Taiman, Moskey, Albano & Shea, LLC,
12 Hartford, Connecticut, for Appellants-Cross-Appellees.

13
14 JOSEPH L. RINI, New Haven, Connecticut, for Appellee-Cross-
15 Appellant John C. Flanagan.
16

17 JAMES C. GRAHAM, Pepe & Hazard, LLP, Hartford, Connecticut, for
18 Appellee-Cross-Appellant Bonnie C. Mangan, Trustee.
19
20 _____

1 CARDAMONE, Circuit Judge:

2 This appeal arises from two separate but related adversary
3 bankruptcy proceedings that we will describe in a moment.
4 Charles A. Flanagan (debtor) filed a petition under Chapter 11 of
5 the U.S. Bankruptcy Code, 11 U.S.C. § 101 et seq., for bankruptcy
6 relief in the United States Bankruptcy Court for the District of
7 Connecticut (Dabrowski, B.J.) on February 17, 1999. While
8 debtor-in-possession under Chapter 11, Flanagan instituted the
9 first adversary proceeding (Preference Action) in the bankruptcy
10 court against Cadle Company to avoid and recover for the bankrupt
11 estate a \$99,542.87 payment he had made to Cadle Company.
12 Following the conversion of Flanagan's Chapter 11 case to one
13 under Chapter 7, Bonnie C. Mangan was appointed trustee of
14 Flanagan's bankrupt estate and substituted as party plaintiff in
15 the Preference Action.

16 Cadle Company and D.A.N. Joint Venture, L.P. (collectively
17 Cadle Creditors or appellants) then brought a second separate
18 adversary proceeding (Constructive Trust Action) seeking a
19 declaratory judgment and the imposition of a constructive trust
20 over certain securities that Flanagan owned prior to the
21 bankruptcy filing. In two memorandum decisions issued on May 22,
22 2003, the bankruptcy court denied the equitable relief requested
23 by the Cadle Creditors and ruled the trustee could avoid the
24 payment from Flanagan to Cadle only to the extent of \$14,542.87.
25 The bankruptcy court went on to hold that the payment was
26 partially protected from avoidance by the earmarking doctrine.

1 Following a motion for reconsideration, the bankruptcy court
2 affirmed its original decisions on July 3, 2003. Both parties
3 appealed. The United States District Court for the District of
4 Connecticut (Arterton, J.) affirmed the decisions of the
5 bankruptcy court on September 30, 2004.

6 As Sir Walter Scott observed "Oh, what a tangled web we
7 weave, when first we practise to deceive." Marmion, Canto VI,
8 Stanza 17 (1808). Such well describes the circumstances of the
9 debtor's conduct revealed by the record in the appeal before us.
10 Fortunately, these tangled facts were carefully sorted out in the
11 bankruptcy court in its decisions and in the district court's
12 September 30, 2004 decision affirming the judgment of the
13 bankruptcy court. We now in turn affirm the judgment of the
14 district court.

15 BACKGROUND

16 The facts of this case were laid out in detail by the
17 district court in Cadle Co. v. Mangan, 316 B.R. 11, 14-17 (D.
18 Conn. 2004). Nonetheless, for purposes of clarity and analysis,
19 we include a summary of those facts relevant to the disposition
20 of this appeal.

21 Prior to Flanagan's bankruptcy filing of February 17, 1999,
22 the Cadle Creditors obtained several money judgments against
23 Flanagan in federal and state court. Most significant for our
24 purposes is a judgment obtained by Cadle against Flanagan on
25 March 20, 1997 in the United States District Court for the
26 District of Connecticut (Covello, J.) in the amount of \$90,747.87

1 (federal judgment). Among Flanagan's assets at the time of the
2 federal judgment was a 50 percent equity interest in Thompson &
3 Peck, Inc. and Flanagan/Prymus Insurance Group, Inc.
4 (collectively Thompson & Peck), valued in excess of \$100,000.
5 Flanagan had possession of the Thompson & Peck stock certificates
6 at the time of the federal judgment in March 1997. In September
7 1997 he transferred the certificates to Socrates Babacas as
8 security for loans made by Babacas to him in the amount of
9 \$85,000 (Babacas loan).

10 Cadle's attempts to locate assets with which to satisfy its
11 federal judgment focused principally upon Flanagan's equity
12 interest in Thompson & Peck. In March 1998 Cadle subpoenaed
13 Flanagan to appear before Judge Covello for an examination of the
14 debtor and for Flanagan to produce, inter alia, "[a]ll documents
15 and communications related to or evidencing any interest which
16 [Flanagan] may hold in Thompson & Peck, Inc." Flanagan appeared
17 for the hearing but did not produce any documents that would
18 reveal his interest in Thompson & Peck. On March 12, 1998 Cadle
19 made a motion for a turnover order commanding Flanagan to "turn
20 over all evidence of . . . ownership and/or other interest in
21 Thompson & Peck . . . including any and all stock certificates in
22 [his] possession, under [his] control and/or available to [him]."
23 The turnover order was granted by the district court on April 13,
24 1998 and upheld on reconsideration.

25 Despite this court order, Flanagan persistently failed to
26 comply with its instructions. Consequently, on November 16, 1998

1 a hearing was held at which Flanagan was ordered to show cause
2 why he should not be held in contempt for his failure to comply
3 with the court's turnover order. At the conclusion of the
4 hearing, Judge Covello found Flanagan had willfully and
5 intentionally not complied with the turnover order and ordered
6 him committed to the Bureau of Prisons until he complied. The
7 execution of the contempt order was stayed and a hearing
8 scheduled a week later to allow Flanagan one final opportunity to
9 comply.

10 When Flanagan's father, John Flanagan, learned that his son
11 was facing contempt sanctions, he lent him \$100,222.87 for the
12 purpose of satisfying the federal judgment (family loan). John
13 Flanagan had never loaned money to his son before and did so on
14 this occasion only to prevent Charles Flanagan from being
15 imprisoned and to protect the family's reputation. The family
16 loan was secured by the debtor's equity interest in Thompson &
17 Peck and Flanagan arranged for Babacas to deliver the stock
18 certificates to his father's home. Immediately upon receipt of
19 the family loan, Flanagan delivered the funds to his lawyer so
20 that the federal judgment could be satisfied. On November 20,
21 1998 Flanagan's attorney deposited the funds into the registry of
22 the district court and Cadle received payment on December 3, 1998
23 (Payment).

24 Following Flanagan's bankruptcy and the filing of the
25 Preference Action to avoid and recover the Payment as a
26 preferential transfer under 11 U.S.C. § 547, the Cadle Creditors

1 mounted a two-pronged defense. In the Preference Action and in
2 the Constructive Trust Action instituted by appellants, the Cadle
3 Creditors sought the imposition of a constructive trust over the
4 Thompson & Peck stock for their benefit. Appellants argued it
5 was solely because of Flanagan's wrongful concealment of his
6 equity interest in Thompson & Peck that they had been unable to
7 execute upon the stock and secure the federal judgment and other
8 judgments they had obtained prior to the 90-day preference
9 period. Thus, they sought the imposition of a constructive trust
10 over the Thompson & Peck stock to restore them to the secured
11 position they would have occupied absent Flanagan's misconduct.
12 The Cadle Creditors asserted the Payment did not improve their
13 position relative to other creditors (as required by 11 U.S.C.
14 § 547(b)(6)) because, due to their constructive possession of the
15 Thompson & Peck stock, the Cadle Creditors possessed a fully
16 secured lien in the stock prior to the preference period.

17 The second prong of the Cadle Creditors' defense against the
18 Preference Action was their argument that the family loan funds
19 had been earmarked by John Flanagan for the sole and specific
20 purpose of satisfying the federal judgment against his son.
21 Accordingly, they maintained that the family loan funds had never
22 constituted an "interest of the debtor in property" as required
23 by § 547(b).

24 The bankruptcy court resolved the Preference Action and the
25 Constructive Trust Action in two decisions issued on May 22,
26 2003. Both decisions were upheld on reconsideration and a

1 modified opinion was issued in the Preference Action on July 3,
2 2003. In response to Cadle's constructive trust claim, the
3 bankruptcy court found the imposition of a trust inappropriate in
4 the circumstances. It noted the Cadle Creditors possessed "only
5 an expectation of the potential fruits of execution [on the
6 stock]," and concluded that a constructive trust should not be
7 imposed to "protect property rights which may or may not have
8 become vested and indefeasible."

9 The bankruptcy court also ruled the Payment was partially
10 protected from avoidance by the earmarking doctrine because the
11 family loan was made for the sole and specific purpose of
12 enabling Flanagan to satisfy the federal judgment. But the
13 bankruptcy court further held that "even though the transaction
14 fits the earmarking defense insofar as it replaced one creditor
15 (Cadle) with another ([John] Flanagan), the substitution of a
16 secured for an unsecured obligation attenuates that defense
17 because, and to the extent, it caused a diminution to Flanagan's
18 personal estate." As a consequence, the bankruptcy court entered
19 judgment in favor of the trustee to avoid the transfer but only
20 to the extent of \$14,542.87, an amount equal to the difference
21 between the family loan and the Babacas loan whose security
22 interest had been supplanted.

23 The Preference Action and the Constructive Trust Action were
24 consolidated on appeal to the district court. On September 30,
25 2004 Judge Arterton of the United States District Court for the
26 District of Connecticut affirmed the decisions of the bankruptcy

1 court. The Cadle Creditors appealed, and the trustee, Bonnie C.
2 Mangan, together with John and Charles Flanagan (appellees)
3 cross-appealed.

4 Meanwhile, the Cadle Creditors instituted two additional
5 proceedings against Charles Flanagan: (1) a civil RICO action in
6 the United States District Court for the District of Connecticut
7 (Covello, J.) alleging, inter alia, fraud and conspiracy in
8 connection with resisting creditors' collection efforts, and (2)
9 an adversary proceeding in bankruptcy court seeking denial of
10 discharge. In 2004, the discharge action was withdrawn from the
11 bankruptcy court and consolidated with the RICO action in the
12 district court before Judge Covello.

13 On April 8, 2005 while the instant appeal was pending, the
14 Cadle Creditors and Flanagan entered into a proposed settlement
15 agreement in the consolidated RICO/discharge action. As part of
16 the proposed settlement, the Cadle Creditors and Flanagan entered
17 into a "Mutual Release of All Claims" (General Release) which
18 stated

19 Upon execution of this Release, both Cadle
20 and Flanagan hereby release each other of and
21 from any and all claims, whether now known or
22 unknown, whether now in existence or arising
23 hereafter, which each has or may have against
24 each other from the beginning of time until
25 the date of the execution of this Release.
26

27 Judge Covello entered an order approving the proposed settlement
28 on May 5, 2005, and dismissing the RICO/discharge action with
29 prejudice.

1 DISCUSSION

2 I Jurisdiction

3 The first issue we address is whether, in light of the
4 General Release, we retain subject matter jurisdiction over that
5 portion of the appeal relating to the Constructive Trust Action.
6 Appellees assert that by executing the General Release the Cadle
7 Creditors relinquished all claims against Flanagan, including
8 claims against Flanagan's bankrupt estate. The trustee thus
9 reasons the Cadle Creditors have extinguished the basis for the
10 relief sought in the Constructive Trust Action, rendering that
11 portion of the appeal moot.

12 In order for there to be a valid exercise of subject matter
13 jurisdiction, a federal court must have before it an actual
14 controversy at all stages of review, not simply at the time the
15 complaint was filed. Steffel v. Thompson, 415 U.S. 452, 459 n.10
16 (1974). In general, if an event occurs while an appeal is
17 pending that renders it impossible for the court to grant any
18 form of effectual relief to plaintiff, the matter becomes moot
19 and subject matter jurisdiction is lost. Altman v. Bedford Cent.
20 Sch. Dist., 245 F.3d 49, 69 (2d Cir. 2001); see also Church of
21 Scientology of Cal. v. United States, 506 U.S. 9, 12 (1992).
22 However, when an appellant retains an interest in a case so that
23 a favorable outcome could redound in its favor, the case is not
24 moot. See Firefighters Local Union No. 1784 v. Stotts, 467 U.S.
25 561, 568-72 (1984).

1 The crux of the trustee's contention is that the Cadle
2 Creditors' claims against Flanagan's bankrupt estate became
3 unenforceable when they entered into the post-petition settlement
4 agreement with the debtor that included a mutual general release
5 of all claims. In making this argument, appellees rely on
6 language in § 502(b)(1) of the Bankruptcy Code. That section
7 states a claim is disallowed in bankruptcy to the extent that it
8 is "unenforceable against the debtor and property of the debtor,
9 under any agreement or applicable law for a reason other than
10 because such claim is contingent or unmatured." 11 U.S.C.
11 § 502(b)(1). The trustee asserts that § 502(b)(1) should be read
12 to disallow not only claims that are unenforceable against the
13 debtor at the time the bankruptcy petition is filed but also
14 those claims that become unenforceable against the debtor over
15 the course of the bankruptcy and prior to discharge.

16 We think the trustee's interpretation of § 502(b)(1) is an
17 untenable reading of the statutory text because it ignores the
18 provision's context within the Bankruptcy Code. Section 502(b)
19 instructs the bankruptcy court to "determine the amount of such
20 claim . . . as of the date of the filing of the petition" except
21 to the extent that "such claim is unenforceable against the
22 debtor." 11 U.S.C. § 502(b), (b)(1) (emphasis added). A plain
23 reading of the statute thus suggests that the bankruptcy court
24 should determine whether a creditor's claim is enforceable
25 against the debtor as of the date the bankruptcy petition was
26 filed. Were this Court to adopt the trustee's interpretation of

1 § 502(b)(1), we would be forced to conclude that all pre-petition
2 unsecured claims are disallowed to the extent they did not
3 represent non-dischargeable debts. For, as the bankruptcy court
4 aptly noted in In re Strangis, 67 B.R. 243 (Bankr. D. Minn.
5 1986), "[a]bsent a finding of nondischargeability, no such
6 unsecured claim is enforceable post-petition against a debtor and
7 property of a debtor." Id. at 246.

8 The General Release could not have impacted any claims held
9 by or against Flanagan's bankrupt estate for an additional and
10 related reason. Flanagan simply did not have the authority to
11 settle any claims against the bankrupt estate. It is well
12 established that once a trustee is appointed, a debtor loses all
13 authority to litigate any claim for or against the estate. As
14 noted in Collier on Bankruptcy

15 The trustee, as representative of the
16 estate, has the exclusive capacity to sue and
17 be sued on behalf of the estate, and is
18 charged by law with representing the interest
19 of the estate against third parties claiming
20 adversely to it. . . .

21 . . . After appointment of a trustee, a
22 debtor no longer has standing to pursue a
23 cause of action that existed at the time the
24 order for relief was entered. Only the
25 trustee has the authority and discretion to
26 prosecute, defend and settle, as appropriate
27 in its judgment, such a cause of action.

28
29
30 3 Collier on Bankruptcy ¶ 323.03, .03[1], at 323-7 to -9 (Alan N.
31 Resnick et al. eds., rev. 15th ed. 2007); see also 10 Collier on
32 Bankruptcy ¶ 6009.03, at 6009-3 to -6.1.

1 Here, not only was the trustee not a party to the General
2 Release, but there is no indication the bankruptcy court was ever
3 presented with a motion to settle, compromise, disallow, or
4 otherwise dismiss the Cadle Creditors' claims. See Fed. Bankr.
5 R. 9019 ("On motion by the trustee and after notice and a
6 hearing, the court may approve a compromise or settlement."); 10
7 Collier on Bankruptcy ¶ 9019.01, at 9019-2 (noting that any
8 "settlement must be approved by the court"). While Flanagan may
9 have had the authority to settle civil claims that arose against
10 him after his bankruptcy filing, he had no authority to settle
11 claims against the bankrupt estate.

12 Having established that the bases for the relief sought by
13 the Cadle Creditors in the Constructive Trust Action have not
14 been extinguished, and that a favorable result could redound in
15 their favor, we conclude those claims are not moot. Hence, we
16 retain subject matter jurisdiction to review them.

17 II Standard of Review

18 In an appeal from a district court's review of a bankruptcy
19 court's decision, we conduct an independent examination of the
20 bankruptcy court's decision. Supplee v. Bethlehem Steel Corp.
21 (In re Bethlehem Steel Corp.), 479 F.3d 167, 172 (2d Cir. 2007).
22 The bankruptcy court's factual findings will be upheld unless
23 clearly erroneous, and its legal conclusions are reviewed de
24 novo. Id. The ultimate determination of whether or not to
25 impose an equitable remedy -- such as a constructive trust or an
26 equitable lien -- is reviewed for abuse of discretion. See

1 Adelphia Bus. Solutions, Inc. v. Abnos, 482 F.3d 602, 607 (2d
2 Cir. 2007) (bankruptcy court's decision whether to exercise its
3 equitable authority is reviewed only for abuse of discretion);
4 see also Burkhardt Grob Luft und Raumfahrt GmbH v. E-Systems,
5 Inc., 257 F.3d 461, 469 (5th Cir. 2001) ("Because a constructive
6 trust is an equitable remedy, the decision whether to impose it
7 is entrusted to the discretion of the district court, and we
8 review the district court's decision only for an abuse of
9 discretion."). However, legal determinations upon which the
10 dispensation of equitable relief may depend are reviewed de novo.
11 See Superintendent of Ins. v. Ochs (In re First Cent. Fin.
12 Corp.), 377 F.3d 209, 213 (2d Cir. 2004) (reviewing de novo the
13 legal conclusion as to whether a party has been unjustly
14 enriched).

15 III General Law on Transfer Avoidance

16 Pursuant to § 547(b) of the Bankruptcy Code, a trustee in
17 bankruptcy may avoid certain transfers if the following criteria
18 are met:

- 19 (1) the transfer is of an interest of the
- 20 debtor in property;
- 21 (2) to or for the benefit of a creditor;
- 22 (3) on account of an antecedent debt;
- 23 (4) made while the debtor was insolvent;
- 24 (5) within 90 days of bankruptcy or within a
- 25 year of bankruptcy if the creditor was an
- 26 insider;
- 27 (6) and the transfer enabled the creditor to
- 28 receive more than it would have received in a
- 29 chapter 7 liquidation had the transfer not
- 30 taken place.

1 11 U.S.C. § 547(b). The burden of proof to establish each of
2 these elements by a preponderance of the evidence rests on the
3 trustee in bankruptcy. Lawson v. Ford Motor Co. (In re Roblin
4 Indus., Inc.), 78 F.3d 30, 34 (2d Cir. 1996). The Cadle
5 Creditors do not contest that the Payment was made within 90 days
6 of Flanagan's bankruptcy, while he was insolvent, on account of
7 an antecedent debt, and for the benefit of a creditor. It is
8 therefore only the first and sixth of these criteria that are at
9 issue in this appeal.

10 IV Transfer Improves Cadle Creditors' Position in Bankruptcy

11 A. The Constructive Trust Claim

12 Concerning the sixth criterion required by 11 U.S.C.
13 § 547(b), the Cadle Creditors aver that the Payment did not
14 improve their position in bankruptcy. They allege that as a
15 result of their constructive possession of the Thompson & Peck
16 stock, they possessed a fully secured lien in the stock. The
17 imposition of a constructive trust is necessary, they insist, to
18 remedy the harm caused by Flanagan's willful failure to comply
19 with the turnover order, which prevented them from perfecting
20 their judgments more than 90 days prior to the bankruptcy filing.
21 We believe the lower courts' refusal to impose a constructive
22 trust on the Thompson & Peck stock was well founded.

23 The effect of a constructive trust in bankruptcy is
24 profound. While the bankrupt estate is defined very broadly
25 under § 541(a)(1) of the Bankruptcy Code to include all legal or
26 equitable interests of the debtor, any property that the debtor

1 holds in constructive trust for another is excluded from the
2 estate pursuant to § 541(d), which states

3 Property in which the debtor holds, as of the
4 commencement of the case, only legal title
5 and not an equitable interest . . . becomes
6 property of the estate . . . only to the
7 extent of the debtor's legal title to such
8 property, but not to the extent of any
9 equitable interest in such property that the
10 debtor does not hold.

11
12 11 U.S.C. § 541(a)(1), (d); see also Sanyo Elec., Inc. v.
13 Howard's Appliance Corp. (In re Howard's Appliance Corp.), 874
14 F.2d 88, 93 (2d Cir. 1989). A constructive trust thus places its
15 beneficiary ahead of other creditors with respect to the trust
16 res.

17 The question of whether the imposition of a constructive
18 trust is appropriate in a particular set of circumstances is
19 governed, in the first instance, by state law. See id.; see also
20 Butner v. United States, 440 U.S. 48, 54-55 (1979). The Supreme
21 Court of Connecticut has stated:

22 [A] constructive trust arises contrary to
23 intention and in invitum, against one who, by
24 fraud, actual or constructive, by duress or
25 abuse of confidence, by commission of wrong,
26 or by any form of unconscionable conduct,
27 artifice, concealment, or questionable means,
28 or who in any way against equity and good
29 conscience, either has obtained or holds the
30 legal right to property which he ought not,
31 in equity and good conscience, hold and
32 enjoy.

33
34 Wendell Corp. Tr. v. Thurston, 680 A.2d 1314, 1317 (Conn. 1996).

35 It is uncontested that Flanagan wrongfully concealed evidence of
36 his equity interest in Thompson & Peck. While such conduct could

1 potentially give rise to a constructive trust in other
2 circumstances, it did not do so here because the Cadle Creditors
3 would not be the proper beneficiaries of such a trust.

4 A constructive trust has been imposed most often by
5 Connecticut courts "to restore to the plaintiff property of which
6 he has been unjustly deprived." Cadle Co. v. Gabel, 794 A.2d
7 1029, 1037 (Conn. App. Ct. 2002) (quoting Restatement (First) of
8 Restitution § 160 cmt. d (1937)); see also Starzec v. Kida, 438
9 A.2d 1157 (Conn. 1981) (affirming imposition of constructive
10 trust for benefit of testator's children where testator gave
11 property to second wife on condition she devise property to his
12 children); Cohen v. Cohen, 438 A.2d 55 (Conn. 1980) (affirming
13 imposition of constructive trust over condominium property where
14 plaintiff conveyed property to son under oral agreement pursuant
15 to which son was to reconvey property back to plaintiff at her
16 request).

17 Here, the Cadle Creditors were never entitled to an
18 ownership interest in the Thompson & Peck stock. Rather, under
19 Connecticut's post-judgment remedy statute, the turnover order
20 only entitled appellants to gain possession of the stock as the
21 first of several steps in executing a levy upon it. See Mangan,
22 316 B.R. at 20-21 (describing and applying to the facts of this
23 case Connecticut's post-judgment remedy statute). As the
24 district court aptly noted:

25 [Appellants'] interests in the stock were
26 subject to a series of contingencies, in
27 which other creditors with secured interests

1 in the stock were entitled to prevent
2 execution or gain priority status over
3 Appellants. The distinction here -- that the
4 turnover order did not entitle Appellants to
5 own Flanagan's stock, just to gain possession
6 as an aid to execution of a levy upon it --
7 is one that Appellants appear to have
8 blurred.

9
10 Id. at 21. Indeed, once the federal judgment had been satisfied
11 by Flanagan with the family loan funds, Cadle lost any
12 expectation interest in the Thompson & Peck stock it might have
13 once had as a result of the district court's turnover order.

14 The Cadle Creditors point out Connecticut courts have in
15 some situations imposed a constructive trust when the plaintiff
16 was not entitled to an ownership interest in the trust property
17 and had not suffered a loss commensurate to the benefit received
18 by the defendant. See, e.g., Gabel, 794 A.2d at 1039 (allowing
19 for constructive trust over property in favor of plaintiff
20 unsecured creditor because defendant had been unjustly enriched
21 by sham transactions used to shield property from creditors). In
22 these situations, "the defendant is compelled to surrender the
23 benefit on the ground that he would be unjustly enriched if he
24 were permitted to retain it." Id. at 1037.

25 However, the argument that Flanagan would be unjustly
26 enriched absent the imposition of a constructive trust is
27 unconvincing when made in the context of a bankruptcy proceeding.
28 See First Cent., 377 F.3d at 218 ("[W]e believe it important to
29 carefully note the difference between constructive trust claims
30 arising in bankruptcy as opposed to those that do not . . .").

1 It has been observed that the "equities of bankruptcy are not the
2 equities of the common law." XL/Datacomp, Inc. v. Wilson (In re
3 Omegas Group, Inc.), 16 F.3d 1443, 1452 (6th Cir. 1994). This is
4 particularly true in the context of constructive trust law. As
5 discussed above, the effect of a constructive trust in bankruptcy
6 is to take the property out of the debtor's estate and to place
7 the constructive trust claimant ahead of other creditors with
8 respect to the trust res. 11 U.S.C. § 541(a)(1), (d); Howard's
9 Appliance, 874 F.2d at 93. It is therefore not the debtor who
10 generally bears the burden of a constructive trust in bankruptcy,
11 but the debtor's general creditors. This type of privileging of
12 one unsecured claim over another clearly thwarts the principle of
13 ratable distribution underlying the Bankruptcy Code. As a
14 consequence bankruptcy courts have been reluctant, absent a
15 compelling reason, to impose a constructive trust on the property
16 in the estate. See First Cent., 377 F.3d at 217-18 (collecting
17 cases); Haber Oil Co. v. Swinehart (In re Haber Oil Co.), 12 F.3d
18 426, 436 (5th Cir. 1994); Omegas Group, 16 F.3d at 1452
19 ("Constructive trusts are anathema to the equities of bankruptcy
20 since they take from the estate, and thus directly from competing
21 creditors, not from the offending debtor.").

22 The Cadle Creditors make no argument as to why Flanagan's
23 bankrupt estate or, more to the point, Flanagan's general
24 creditors, would be unjustly enriched by the estate's continued
25 ownership interest in the Thompson & Peck stock. Accordingly, we

1 affirm the bankruptcy court's refusal to impose a constructive
2 trust on the stock.

3 B. Availability of an Equitable Lien

4 In the alternative, the Cadle Creditors declare that an
5 equitable lien should be imposed on the Thompson & Peck stock to
6 the extent of their claims. This point was not raised before the
7 bankruptcy court, but appears to have been prompted by language
8 in the district court's opinion. In noting that the appellants
9 were not claiming they rightfully owned the stock, but only that
10 they were entitled to reach the stock as security for their
11 claims, the district court observed that an "equitable remedy
12 that would give Cadle a perfected lienholder status might be best
13 described as an 'equitable lien.'" Mangan, 316 B.R. at 22. The
14 district court then went on to dismiss the possibility of
15 imposing an equitable lien because it concluded that "an
16 equitable lien, even if enforceable, would not relate back" to
17 before the preference period. Id. at 23.

18 We generally will not consider arguments raised for the
19 first time on appeal. Universal Church v. Geltzer, 463 F.3d 218,
20 228 (2d Cir. 2006). We do, however, retain discretion to
21 consider an argument not presented to the trial court in order to
22 prevent a manifest injustice or where the argument presents a
23 question of law and additional factfinding is unnecessary. Id.
24 Because the district court considered the equitable lien issue
25 and because the imposition of an equitable lien on the facts of

1 this case raises only a question of law, we briefly consider the
2 matter.

3 Connecticut law recognizes the equitable lien remedy. See,
4 e.g., Hansel v. Hartford-Conn. Trust Co., 49 A.2d 666, 673 (Conn.
5 1946); Bassett v. City Bank & Trust Co. (In re Judd), 165 A. 557,
6 561-62 (Conn. 1933). The equitable remedy was aptly described by
7 the Connecticut Supreme Court in Hansel

8 An equitable lien creates merely a charge
9 upon the property and when the person
10 entitled to it is not in possession of that
11 property, he has no right to obtain
12 possession from another unless by virtue of
13 some authority to do so expressly granted to
14 him; his remedy to enforce the lien is by a
15 proceeding in equity to bring about its sale
16 and the application of the proceeds to the
17 satisfaction of the obligation secured, or,
18 in some other manner, by order of the court,
19 to make the property available for the
20 discharge of that debt.

21
22 Hansel, 49 A.2d at 673.

23 Equitable liens arise in a variety of circumstances. For
24 example, an equitable lien may arise by express or implied-in-
25 fact agreement of the parties. See, e.g., Bassett, 165 A. at
26 561; see also Dan B. Dobbs, 1 Law of Remedies § 4.3(3), at 601
27 (2d ed. 1993). Most often, however, equitable liens are imposed
28 to prevent unjust enrichment. See Dep't of the Army v. Blue Fox,
29 Inc., 525 U.S. 255, 262-63 (1999). In this sense, equitable
30 liens and constructive trusts share the same substantive basis;
31 both are remedies in equity to redress unjust enrichment. See
32 Dobbs, supra, § 4.3(3), at 601 ("The [equitable] lien is imposed

1 for reasons that, in principle, are the same as those that
2 warrant the constructive trust").

3 The traditional distinction between a constructive trust and
4 an equitable lien is that the beneficiary of a constructive trust
5 receives complete title to the asset whereas the holder of an
6 equitable lien receives only a lien on the asset through which it
7 may satisfy a money claim. See Airwork Corp. v. Markair Express,
8 Inc. (In re Markair, Inc.), 172 B.R. 638, 643 (B.A.P. 9th Cir.
9 1994); Dobbs, supra, § 4.3(3), at 601. Yet, in some states --
10 including Connecticut -- there is little practical difference
11 between the two remedies because courts have held that a
12 constructive trust beneficiary does not necessarily obtain a
13 right to possess the trust property, but may only receive a lien
14 on the property equal to the amount of the plaintiff's claim.
15 See Wendell 680 A.2d at 1320 ("To say that the . . . property is
16 subject to a constructive trust in Wendell's favor is not to say
17 that Wendell owns the property. On the contrary, it is to say
18 only that Wendell may seek satisfaction of its debt, and no more,
19 out of that property"). Thus, in Connecticut, the right
20 to recover under a constructive trust is limited in a similar way
21 as it would be under an equitable lien theory.

22 The Cadle Creditor's contention that they should receive an
23 equitable lien on the stock fails for the same reason as their
24 constructive trust argument. Both the equitable lien and
25 constructive trust remedies are equitable devices to prevent
26 unjust enrichment. But, as discussed above, appellants have

1 failed to demonstrate how Flanagan's bankrupt estate would be
2 unjustly enriched by its continued ownership interest in the
3 Thompson & Peck stock. Because no equitable lien arises in these
4 circumstances, we need not review the district court's conclusion
5 that, even if an equitable lien did arise, it would not relate
6 back to a time before the preference period.

7 V Earmarking Doctrine

8 In order for a transfer to be avoidable by a trustee in
9 bankruptcy, it must be of "an interest of the debtor in
10 property." 11 U.S.C. § 547(b). The requirement that the
11 transfer be of an interest of the debtor in property is not
12 defined in the Bankruptcy Code and has therefore been left to the
13 courts to interpret. In so doing, courts have crafted a doctrine
14 that has come to be known as the earmarking doctrine.

15 The earmarking doctrine applies "where a third party lends
16 money to the debtor for the specific purpose of paying a selected
17 creditor." Glinka v. Bank of Vt. (In re Kelton Motors, Inc.), 97
18 F.3d 22, 28 (2d Cir. 1996). In such situations, the loan funds
19 are said to be "earmarked" and the payment is held not to
20 constitute a voidable preference. McCuskey v. Nat'l Bank of
21 Waterloo (In re Bohlen Enters.), 859 F.2d 561, 565 (8th Cir.
22 1988).

23 Early applications of the earmarking doctrine concerned
24 situations in which the debtor's obligation was secured by a
25 guarantor. See id. Where the guarantor paid the creditor on
26 behalf of a debtor, the courts rejected the proposition that the

1 payment could be avoided by the trustee. Id. The rationale for
2 such an outcome was that the property transferred belonged to the
3 guarantor and thus the transfer of that property in no way
4 diminished the debtor's estate. See Nat'l Bank of Newport, N.Y.
5 v. Nat'l Herkimer County Bank, 225 U.S. 178, 185 (1912) ("Neither
6 directly nor indirectly was this payment to the bank made by the
7 [debtor], and the property of [the debtor] was not thereby
8 depleted."). It is likely that courts were also mindful that the
9 opposite result would have the inequitable effect of forcing the
10 guarantor to pay the same obligation twice. See McCuskey, 859
11 F.2d at 565.

12 Today, the earmarking doctrine has been extended beyond the
13 guarantor context and several courts have held that it applies
14 whenever a third party provides funds to the debtor for the
15 express purpose of enabling the debtor to pay a specified
16 creditor, that is substituting a new creditor for an old
17 creditor. See Glinka, 97 F.3d at 28; Adams v. Anderson (In re
18 Superior Stamp & Coin Co.), 223 F.3d 1004, 1008 (9th Cir. 2000);
19 Buckley v. Jeld-Wen, Inc. (In re Interior Wood Prods. Co.), 986
20 F.2d 228, 231 (8th Cir. 1993); In re Smith, 966 F.2d 1527, 1533
21 (7th Cir. 1992); Mandross v. Peoples Banking Co. (In re Hartley),
22 825 F.2d 1067, 1070 (6th Cir. 1987); Coral Petrol., Inc. v.
23 Banque Paribas-London, 797 F.2d 1351, 1356 (5th Cir. 1986). But
24 see Manchester v. First Bank & Trust Co. (In re Moses), 256 B.R.
25 641, 646-49 (B.A.P. 10th Cir. 2000) (stating that the earmarking
26 doctrine should not be extended beyond guarantor situations);

1 McCuskey, 859 F.2d at 566 (expressing doubt as to whether
2 earmarking doctrine should be extended beyond guarantor
3 situations but ultimately adopting test that allows for
4 application of earmarking doctrine outside that limited context).

5 Several formulations have been developed to determine
6 whether the earmarking doctrine applies in a particular case.
7 See Manchester, 256 B.R. at 649-50 (discussing various approaches
8 to application of earmarking doctrine). An oft cited approach is
9 that adopted by the Eighth Circuit in McCuskey. McCuskey held
10 that in order for a transaction to qualify under the earmarking
11 doctrine, three requirements must be satisfied: "(1) the
12 existence of an agreement between the new lender and the debtor
13 that the new funds will be used to pay a specified antecedent
14 debt, (2) performance of that agreement according to its terms,
15 and (3) the transaction viewed as a whole (including the transfer
16 in of the new funds and the transfer out to the old creditor)
17 does not result in any diminution of the estate." 859 F.2d at
18 566; see also Kaler v. Cmty. First Nat'l Bank (In re Heitkamp),
19 137 F.3d 1087, 1088-89 (8th Cir. 1998) (applying McCuskey
20 formulation). Other courts have focused primarily on whether the
21 debtor lacked control over the funds supplied by the new
22 creditor. See, e.g., Hansen v. MacDonald Meat Co. (In re Kemp
23 Pac. Fisheries, Inc.), 16 F.3d 313, 316 (9th Cir. 1994); Coral,
24 797 F.2d at 1358.

25 We have long recognized the earmarking doctrine, though our
26 early cases did not refer to it by that name. See, e.g., Smyth

1 v. Kaufman (In re J.B. Koplik & Co.), 114 F.2d 40, 42-43 (2d Cir.
2 1940); Grubb v. Gen. Contract Purchase Corp., 94 F.2d 70, 72-73
3 (2d Cir. 1938) (L. Hand, J.). We have held that where a debtor
4 receives funds subject to a clear obligation to use that money to
5 pay off a preexisting debt, and the funds are in fact used for
6 that purpose, those funds do not become part of the estate and
7 the transfer cannot be avoided in bankruptcy. See Grubb, 94 F.2d
8 at 73. However, we have been equally clear that where a new
9 creditor provides funds to the debtor with no specific
10 requirement as to their use, the funds do become part of the
11 estate and any transfer of the funds out of the estate is
12 potentially subject to trustee's avoidance powers. See Smyth,
13 114 F.2d at 42 (finding that transfer could be avoided where
14 "nothing indicat[ed] that [the new creditor] loaned this \$500 on
15 condition that it should be applied to this particular
16 creditor."). This result does not change even where the new
17 creditor knows, but does not require, that the new loan funds
18 will be used to pay off a preexisting debt. See id.

19 In this case, the bankruptcy court found that Flanagan's
20 father provided the family loan for the specific purpose of
21 paying the federal judgment. There was no doubt that the
22 debtor's father made such funds available "for the sole purpose
23 of purging Flanagan's contempt before Judge Covello through
24 satisfaction of the underlying Judgment." This factual finding
25 is not clearly erroneous and we accept it on this appeal.

1 The trustee does not seriously dispute that the family loan
2 was made for the purpose of allowing Flanagan to pay the federal
3 judgment. She insists, however, that the earmarking defense does
4 not apply because Flanagan obtained possession of the funds
5 temporarily. The fact that Flanagan temporarily had possession
6 of the family loan funds does not necessarily demonstrate that
7 Flanagan had control of them. The proper application of the
8 earmarking doctrine depends not on whether the debtor temporarily
9 obtains possession of new loan funds, but instead on whether the
10 debtor is obligated to use those funds to pay an antecedent debt.
11 See 5 Collier on Bankruptcy ¶ 547.03[2], at 547-24 ("The
12 [earmarking] rule is the same regardless of whether the proceeds
13 of the loan are transferred directly by the lender to the
14 creditor or are paid to the debtor with the understanding that
15 they will be paid to the creditor in satisfaction of his claim
16"); see also Superior Stamp, 223 F.3d at 1009. Compare
17 Grubb, 94 F.2d at 73 with Smyth, 114 F.2d at 42. Flanagan's
18 receipt of the family loan funds was specifically conditioned
19 upon his use of those funds to pay the federal judgment, and he
20 never obtained control of the funds in the sense of being able to
21 control how they were ultimately distributed. The earmarking
22 doctrine therefore potentially applies to protect the Payment
23 from avoidance.

24 There is, nonetheless, an important limitation on the
25 earmarking doctrine. The doctrine will only protect a transfer
26 from avoidance to the extent it did not diminish the debtor's

1 estate. Glinka, 97 F.3d at 28. Where a debtor replaces an
2 unsecured obligation with a secured obligation, the payment is
3 voidable to the extent of the collateral transferred by the
4 debtor. Id. ("[T]o the extent that the debtor offered its own
5 property as collateral for the [loan], the debtor transferred an
6 interest in its property and therefore the earmarking defense is
7 not available."); see also Mandross, 825 F.2d at 1071. In the
8 case at hand, Flanagan satisfied the unsecured obligation of the
9 federal judgment by taking on the secured obligation of the
10 family loan. However, the bankruptcy court also found that the
11 lien obtained by the debtor's father in the Thompson & Peck stock
12 supplanted Babacas's lien in the stock. As a consequence, the
13 bankruptcy court concluded the net diminution of the estate was
14 equal to the difference between the Babacas loan (\$85,000) and
15 the Payment (\$99,542.87), or the extent to which John Flanagan
16 encumbered previously unencumbered property of the debtor estate
17 to enable the Payment.

18 The trustee disputes the bankruptcy court's finding that the
19 family loan lien supplanted, rather than merely subordinated,
20 Babacas's lien. We believe the bankruptcy court's finding that
21 the Babacas lien was supplanted by the family loan lien finds
22 support in the record and is not clearly erroneous.

23 Consequently, we conclude that the Payment can be avoided by the
24 trustee, but only in the amount of \$14,542.87.

CONCLUSION

1
2 Accordingly, for the foregoing reasons, the judgment of the
3 district court is affirmed and appellees' motion to dismiss for
4 lack of subject matter jurisdiction is denied.