

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF

McKAY ENTERPRISES, INC.,

DEBTOR

THOMAS M. LOTT,

Plaintiff

vs.

McKAY ENTERPRISES, INC.,
and FIRSTIER BANK OF OMAHA,
f/k/a Omaha National Bank

Defendants

CASE NO. BK85-689

A85-296

MEMORANDUM OPINION

On November 19, 1987, an evidentiary hearing was held on Thomas M. Lott's complaint. James Miller and Patrick Grewe of Gunderson, Abrahamson & Grewe, Omaha, Nebraska, appeared on behalf of Mr. Lott; David Begley of Kennedy, Holland, Delacy & Svoboda, Omaha, Nebraska, appeared on behalf of FirstTier Bank, f/k/a/ Omaha National Bank; Kathleen Smith of Schmid, Mooney & Frederick, P.C., Omaha, Nebraska, appeared on behalf of the Chapter 11 trustee. Deposition testimony, witnesses and exhibits were received into evidence. The Court found, and all parties agreed, that the Court could enter final judgment. 11 U.S.C. § 157(b). This Memorandum Opinion constitutes findings of fact and conclusions of law required by B.R. 7052 and Fed. R. Civ. P. 52.

Statement of Facts

Thomas M. Lott, although originally from Nebraska, at all times relevant to this action resided in Connecticut and was employed in New York.

In the fall of 1984, Mr. Lott, with the advice of a Lincoln accountant, decided to invest in a hog-feeding operation as an investment vehicle for tax shelter purposes. The Lincoln accountant suggested McKay Enterprises ("McKay") as the feeder and Omaha National Bank, now FirstTier Bank, ("Bank") as the lender.

Mr. Lott testified that he had a telephone conversation with Bank official, Stephen Hatz, to discuss such an investment. According to Mr. Lott, Mr. Hatz told Mr. Lott that McKay was a reputable feeder and that Bank financed McKay's operations.

Bank had extended credit to McKay and as collateral for its operating loans to McKay, Bank held perfected security interests in, inter alia, all McKay's pigs, presently owned or hereafter acquired. Bank had been financing McKay for more than one year before Mr. Lott became involved. Bank also financed other "owners" who, like Mr. Lott, had hogs feeding at McKay's.

Bank agreed to extend a line of credit to Mr. Lott to pay for the purchase, feeding and care of the hogs. The hogs would become collateral for Mr. Lott's loan. Lott testified that he told Mr. Hatz that he lived out of state and could not personally monitor the operation and that he would rely on Bank to monitor his collateral as well as make the necessary monetary transfers to McKay Enterprises for the purchase, feed and care of the hogs.

On October 12, Mr. Lott entered into an agreement with McKay. The agreement provided that McKay would provide feed and care for 2,400 hogs purchased by Mr. Lott and that Mr. Lott would receive semi-monthly bills from McKay. The agreement did not address how sale proceeds would be collected and disbursed.

On November 14, 1984, McKay notified Mr. Lott of the purchase of 2,355 feeder pigs. Billings for the purchase of these pigs were submitted to Lott. The pigs were located in two separate feeding lots, Mullen and Juniata, Nebraska.

On December 6, 1984, Mr. Lott's checking account at Bank was charged for the pig purchase. Throughout the period relevant to this action, McKay submitted regular bills to Mr. Lott for care and feeding of the pigs. To pay the bills, either Mr. Lott or McKay would call Bank and request a draw on Mr. Lott's line of credit. Bank would transfer the amount due from Lott's account in Bank to McKay's account in Bank. Except for one occasion, Mr. Lott made no payments directly to McKay. Bank handled all the transactions. No evidence was presented of money transfers from McKay's account to Mr. Lott's.

In late January, 1985, Bank physically inspected Lott's collateral and provided Mr. Lott with a copy of Bank's head count. This inspection reported a head count of 2,278 pigs belonging to Mr. Lott--77 less than Mr. Lott purchased in November. Mr. Lott did not challenge this count.

In February, 1985, Mr. Lott sold 1,532 hogs on the Futures Market, and the proceeds were paid directly to Mr. Lott. Assuming the Bank inspection to be correct, 746 hogs remained to be sold.

Mr. Lott understood that these 746 hogs would be sold by McKay in late February or March. Mr. Lott testified that he called Bank on several occasions during the month of March informing Mr. Hatz that he anticipated that McKay would deposit proceeds from the sale of the remainder of Mr. Lott's hogs in McKay's account in Bank and asking Mr. Hatz whether those proceeds had been deposited so that a transfer could be arranged from McKay's account to Mr. Lott's. At no time throughout this period did Bank question either Mr. Lott's ownership rights or the number of hogs Mr. Lott claimed he owned.

Deposition testimony with accompanying exhibits from:

Alys Lafler, Computer Operator for McKay for the period relevant to this action; Mary Alice Hodgson, Bookkeeper/Secretary for Bowles Livestock Commission Company in Omaha; Connie J. Busse, Secretary/Bookkeeper of Midwest Livestock Commission Company, Sioux City, Iowa; and Dan McKay, President of McKay Enterprises; indicates that McKay sold Mr. Lott's and other owners' hogs at two locations during late February and March of 1985, Bowles Livestock Commission Company in Omaha and Midwest Livestock Commission Company in Sioux City, Iowa. The proceeds from the sales at these two locations were deposited in McKay's account at Bank, and McKay's account at First National Bank of Sidney. Deposition testimony of Dan McKay indicated that hogs were comingled when shipped for sale and proceeds were allocated to owners on the basis of number of animals sold.

Bank officer, Stephen Hatz, testified that he had not recommended McKay Enterprises to Mr. Lott. He stated that, because a different bank officer, Larry Helling, handled McKay's loan, he had no knowledge that McKay was experiencing financial difficulties until immediately preceding McKay's bankruptcy petition in late March, 1985. As soon as he did know, however, he notified Mr. Lott. Further, Mr. Lott had not telephoned him regarding the whereabouts of the proceeds from the sale of Mr. Lott's hogs until after the bankruptcy filing. He also testified that McKay's account at Bank was used by McKay for general business purposes. In other words, the account was not solely the repository for hog sale proceeds.

Bank official Larry Helling, McKay's loan officer, testified that he, also, was unaware of McKay's situation until a few days before McKay filed its Chapter 11 petition. As soon as Bank knew, Bank officers repossessed all of the hogs it found in McKay's feedlots. When Bank repossessed the hogs it found far less than the number McKay had represented to Bank on the borrowing base certificates.¹ Bank also set off approximately \$67,000 of McKay's

¹McKay was required to maintain collateral equal to a certain percentage of its operating loan. On a regular basis McKay provided to Bank reports--borrowing base certificates--of its collateral and its estimated value.

funds held in McKay's checking account at Bank against a portion of McKay's outstanding operating loan.

Bank's director of security, Marcus Ford, testified that, after reviewing McKay's records, he believed that McKay may have double pledged its assets.

On March 30, 1985, McKay filed for Chapter 11 relief. Trustee has possession of the funds which Mr. Lott alleges were his sale proceeds deposited to First National Bank of Sidney.

Analysis

Mr. Lott brings this action against Bank and Trustee for McKay to recover the proceeds from the sale of 743 of his hogs. His complaint states three separate causes of action:

1. A constructive trust in the amount of \$8,356.20 be imposed upon monies held by Trustee which monies are proceeds of sale of Mr. Lott's hogs and thus property of Mr. Lott;
2. Wrongful set-off by Bank in the amount of \$50,574.20;
3. Breach of fiduciary duty by Bank causing Mr. Lott \$60,841.66 in damages.

Bank contends that Mr. Lott cannot prove ownership of any specific hogs. Bank submits that McKay moved the pigs from pen to pen in a deliberate attempt to misrepresent the number of pigs and to whom they belonged.

Thus, Bank argues, Lott's hogs were McKay's hogs and were already encumbered with Bank's perfected security interest. Bank also claims that even if the proceeds that Bank set off were from the sale of Mr. Lott's hogs, Mr. Lott cannot trace those proceeds to McKay's account at Bank. Further, Bank maintains that no fiduciary duty existed between Bank and Mr. Lott.

Trustee also claims that no fiduciary relationship existed between Trustee and Mr. Lott and that the monies held by Trustee cannot be identified as proceeds of Mr. Lott's hog sale. Thus, the Court cannot impose a constructive trust on those monies.

After reviewing the testimony and evidence, the Court finds that:

1. Mr. Lott was the purchaser of 2,355 hogs which were ultimately sold in the Futures Market, by Midwest Livestock Commission Co. and by Bowles Livestock Commission Co.;

2. Bank acknowledged and recognized Lott's ownership and verified the number of hogs owned by Lott in its January, 1985, inspection;

3. The proceeds from the sale of Mr. Lott's hogs can be traced to the McKay account in Bank and in the McKay account First National Bank of Sidney;

4. Mr. Lott relied on Bank's representation of McKay as a reputable feeder and relied on Bank to monitor his collateral;

5. Mr. Lott gave notice to Bank prior to McKay's Chapter 11 filing of his ownership claim to the sale proceeds in McKay's account at Bank;

6. Mr. Lott did not rely on First National Bank of Sidney for any service, nor did Mr. Lott give First National Bank of Sidney notice of his claim on any proceeds from the sale of his hogs.

Based on these findings, the Court will determine:

- 1) Whether Mr. Lott's notice to Bank of Mr. Lott's claim to monies in McKay's account in Bank is sufficient for Court to invalidate the set-off?
- 2) Whether Mr. Lott's reliance on Bank was sufficient to create a fiduciary relationship between Bank and Mr. Lott?
- 3) If a fiduciary relationship existed, whether Bank's actions constitute a breach of the relationship?
- 4) Whether a constructive trust in favor of Mr. Lott should be imposed on the funds held by trustee?
- 5) If the Court finds unlawful set-off, whether Mr. Lott may recover prejudgment interest?

I.

Bank's set-off occurred prior to McKay's bankruptcy filing, and the set-off has not been challenged by the trustee. Thus, state law rather than federal bankruptcy law must be examined to determine the validity of Mr. Lott's claim of wrongful set-off.

Under Nebraska law, if a bank has either actual knowledge or knowledge of circumstances to provoke inquiry that monies deposited in the account of one of bank's depositors belong to a third person, bank is denied the right of set-off. Union Stock Yards National Bank v. Moore, 79 F. 705 (8th Cir. 1897); Allen Dudley & Co. v. First National Bank of Omaha, 122 Neb. 443, ___ N.W. ___ (1932); Globe Savings Bank v. National Bank of Commerce, 64 Neb. 413, 89 N.W. 1030 (1902).

The Court believes that the evidence is sufficient to support Mr. Lott's claim that Bank knew or should have known that Mr. Lott claimed monies deposited in McKay's account at Bank. Consequently Bank could not, pursuant to Nebraska law, set off funds belonging to Mr. Lott.

To determine whether the monies taken by Bank were proceeds belonging to Mr. Lott requires examination of Nebraska courts' method of tracing funds and the effect of withdrawals and subsequent additions upon those funds. "As to situations covered by Nebraska decisions, the Restatement [of Trusts] states the law of Nebraska with only a few exceptions." Preface to Nebraska Annotations to the Restatement (Second) of Trusts (1971) (quoting Dean Foster). Although McKay's bank account was not a trust account, Mr. Lott's notice to Bank of his ownership claim to monies in the account is sufficient to categorize the proceeds as "trust" funds. Thus, the Restatement (Second) of Trusts provides the appropriate guidance.

Section 202 of the Restatement (Second) of Trusts entitled "Following Trust Property into Its Product" is relevant to the instant facts. The Nebraska Annotations are in general accord with Section 202. Id. at 101. See also City of Lincoln v. Morrison, 64 Neb. 822, 90 N.W. 905 (1902). Comment j of Section 202 reads:

j. Effect of withdrawals and subsequent additions. Where the trustee deposits in a single account in a bank trust funds and his individual funds, and makes withdrawals from the deposit and dissipates the money so withdrawn, and subsequently makes additional deposits of his individual funds in the account, the beneficiary cannot ordinarily enforce an equitable lien upon the deposit for a sum greater than the lowest intermediate balance of the deposit. If the amount on deposit at all times after the deposit of the trust funds equalled or exceeded the amount of the trust funds deposited, the beneficiary is entitled to a lien upon the deposit for the full amount of the trust funds deposited in the account. If after the deposit of trust funds in the account the deposit was wholly exhausted by withdrawals before subsequent deposits of the trustee's individual funds were made, the beneficiary's lien upon the deposit is extinguished, and if he is unable to trace the money withdrawn, he is relegated to a mere personal claim against the trustee, and is entitled to no priority over other creditors of the trustee.

Restatement (Second) of Trusts § 202 Comment j (1959) (emphasis added).

Bank's set-off of approximately \$67,000 occurred on March 28, 1985. Proceeds from the sale of Mr. Lott's hogs were deposited in McKay's account at Bank on six different occasions in March, the last deposit occurring on March 18, 1985. Following this last deposit of proceeds and prior to Bank's set-off, McKay's bank statement reflects additional deposits to the account and additional withdrawals from the account.

The lowest balance in McKay's account following the deposits of all of the hog proceeds claimed by Mr. Lott and before Bank's set-off took place was \$1,890.33 on March 25, 1985. Applying the intermediate balance rule set forth in Section 202 of the Restatement (Second) of Trusts, the Court finds that \$1,890.33 was wrongfully set off by Bank.

II and III.

Again, whether a fiduciary relationship existed between Mr. Lott and Bank, and if it did exist, whether Bank breached this relationship is a function of state law. Nebraska decisional law appears to equate breach of a fiduciary relationship with constructive fraud in equity. See, e.g., Cunningham v. Quinlan, 178 Neb. 687, 134 N.W.2d 822 (1965). To sustain an action for false representation or fraud, Nebraska law requires proof that a false representation was made. Nielsen v. Adams, 223 Neb. 262, 388 N.W.2d 840 (1986); Hahn & Hupf Constr., Inc., v. Highland Heights, 222 Neb. 189, 382 N.W.2d 607 (1986). Mr. Lott points to no Nebraska case which deals with the imposition of a fiduciary relationship between a bank and a customer-obligor.

But the law appears well settled in other jurisdictions that something more than a lender-borrower relationship is required before a fiduciary duty can exist. Kurth v. VanHorn, 380 N.W.2d 693 (Iowa 1986); 70 A.L.R.3d 1344 (1976). That something more appears to be proof of a bank-customer relationship extending beyond a conventional bank-depositor relationship. Bank must know or have reason to know that customer-depositor is relying on it for advice. If that reliance is proven, a fiduciary duty to disclose is imposed upon Bank.' Id. This duty to disclose is compatible with Nebraska law in nonbank-customer cases where the courts require proof of misrepresentation.

The evidence shows that Mr. Lott relied on Bank for its counsel and assurance of McKay's competence, but no evidence of any deception, misrepresentation or nondisclosure by Bank has been presented. Certainly in late March, 1985, McKay exhibited financial difficulties; however, in the fall of 1984 no one--Bank, Mr. Lott or the accountant advising Mr. Lott--knew or had reason to believe that McKay would file for bankruptcy in March, 1985.

All believed McKay to be a reputable feeder operation. In other words, no material facts relevant to Mr. Lott's investment did Bank misrepresent or fail to disclose.

Mr. Lott stated that he relied on Bank to monitor his collateral. Bank did inspect and count the hogs in January, 1985, and Mr. Lott was advised of the result. However, no evidence was produced at the hearing that Bank had agreed to collect the proceeds from the sale of Mr. Lott's hogs. In fact, the proceeds from the first sale of the majority of Mr. Lott's hogs were paid directly to Mr. Lott. The Bank played no part in that transaction.

Mr. Lott testified that he called Bank on several occasions in March, 1985, to inquire whether the proceeds from the sale of his remaining hogs had been deposited in McKay's account. From the number of withdrawals and deposits in that account during March of 1985, and without the benefit of the depositions and other evidence before the Court, the Court doubts that Bank could specifically identify any individual deposit as proceeds from a particular sale. Nor does the Court find from the evidence a duty imposed on Bank, express or implied, to monitor deposits into McKay's bank account or to transfer monies from McKay's account into Mr. Lott's account. Bank notified Mr. Lott when it became aware of McKay's financial difficulties. This information was not withheld.

Therefore, although Mr. Lott sets forth sufficient facts to support the existence of a fiduciary relationship between Bank and himself, the Court finds no failure to disclose nor misrepresentation by Bank. Further, the Court finds Bank had no duty to monitor McKay's bank account for Mr. Lott's benefit. To avoid this result, Mr. Lott's contract with McKay should have provided for his hog sale proceeds to be segregated from McKay's general business account.

IV.

The Court finds accurate trustee's legal arguments outlining the elements required before imposition of a constructive trust: "(1) a wrongful act; (2) specific property acquired by the wrongdoer which is traceable to the wrongful behavior; and (3) an equitable reason why the party holding the property should not be allowed to keep it." In re Independent Clearing House Co., 41 Bankr. 985, 1000 (Bankr. D. Utah 1984) (citations omitted).

In Ruppert v. Breault, 222 Neb. 432, 384 N.W.2d 284 (1986), the Court required a finding of fraud or overreaching to satisfy the "wrongful act" element. In the instant case there is no evidence that the trustee acquired the funds through a fraudulent or improper act. Thus the Court finds no wrongful act by trustee. Because the Court finds no wrongful act by trustee, the Court will not address the remaining two elements required for imposition of a constructive trust.

The Court sustains trustee's objection to the imposition of a constructive trust upon monies in trustee's possession.

V.

Mr. Lott points out that Neb. Rev. Stat. Section 45-104 allows prejudgment interest at the rate of 12 percent on "money received to the use of another and retained without the owner's consent, express or implied." Neb. Rev. Stat. § 45-104 (Reissue 1984). Nebraska courts have awarded prejudgment interest in situations similar to the instant case. See, e.g., Zimmerman v. Martindale, 221 Neb. 344, 377 N.W.2d 94 (1985); Edquist v. Commercial Savings & Loan Ass'n., 191 Neb. 618, 217 N.W.2d 82 (1974).

Bank provided no contrary legal arguments. Bank shall pay interest as set forth in Neb. Rev. Stat. Section 45-104 on the amount determined in Section I, supra.

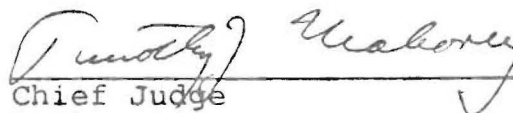
Summary

Therefore, judgment is entered against Bank for wrongful set-off in the sum of \$1,890.33 with interest as provided in Neb. Rev. Stat. Section 45-104 (Reissue 1984). Thomas Lott's complaint that Bank breached a fiduciary duty is overruled, and Thomas Lott's complaint seeking a constructive trust on monies held by trustee is overruled.

Separate Journal Entry will be entered.

DATED: February 29, 1988.

BY THE COURT:


Chief Judge

Copies to each of the following:

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