

COMMONWEALTH OF MASSACHUSETTS

A P P E A L S C O U R T

HAMPDEN, ss.

Sitting 1987

No. A.C. 87-750

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AETNA FIRE UNDERWRITERS INSURANCE COMPANY,  
AETNA INSURANCE COMPANY, CIGNA INSURANCE  
COMPANY, INDEMNITY INSURANCE COMPANY OF  
NORTH AMERICA, and PACIFIC EMPLOYERS  
INSURANCE COMPANY, Plaintiffs-Appellees

v.

BANK OF NEW ENGLAND-WEST, N.A., and  
TRI-TOWN INSURANCE AGENCY, INC.,  
Defendants/Appellants

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On Appeal from an order of the Superior Court  
granting the Plaintiffs' a preliminary injunction

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BRIEF OF THE PLAINTIFFS-APPELLEES

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ISSUES PRESENTED

I. Did Federal law prevent the issuance of an injunction against a national bank?

II. Did the Superior Court err in granting injunctive relief upon a finding of the reasonable likelihood that the Plaintiffs will succeed on the merits?

III. Did the Superior Court err in granting injunctive relief upon a finding that the Plaintiffs would suffer irreparable harm if the injunction were not granted?

STATEMENT OF THE CASE

This action was commenced in the Superior Court on July 14, 1986. The Plaintiffs' (hereinafter "Insurers") verified complaint sought preliminary injunctive relief to enjoin the Bank of New England-West, N.A. (hereinafter "BNE") from seizing the Insurers' policyholders' premiums from the bank account of the Tri-Town Insurance Agency, Inc. (hereinafter "Tri-Town"). The Insurers also requested that the injunction restrain the BNE from setting off Tri-Town's indebtedness to BNE with the Insurers' premiums, and requested that, after a full hearing, a constructive trust be imposed on premiums which had already been seized by BNE. (A. 4).

A hearing was held on a short order of notice on July 15, 1986. The time to file briefs was held open

until July 18, 1986, and both parties filed affidavits. (A. 12, 14, and 15). On July 29, 1986, the Court, Porada, J., granted the Plaintiffs' prayer for a preliminary injunction, issuing an order enjoining BNE from using the Insurers' premiums to set off Tri-Town's indebtedness. (A. 19-21). BNE filed its notice of appeal of the Superior Court's order granting the injunction on August 28, 1986. (A. 22). The record on appeal was completed on June 19, 1987, and the appeal was docketed in the Appeals Court on June 29, 1987.

STATEMENT OF THE FACTS

Pursuant to the Agency Agreement between Tri-Town and the Insurers, premiums collected from policyholders by Tri-Town for insurance policies written by them were due to the Insurers 45 days after the end of the month on which the business was recorded in the Insurers' books. (A. 9, at §2(g)(3)). The Agency/Company agreement further provided:

**b Collection of Premiums**

1 In accordance with our procedures, you will collect, account for and pay premiums on business that you write. You will be responsible for collecting all premiums on business which you solicit and which is accepted by us. You must pay the premium even if you do not collect it from the policyholder.

2 Additional premiums which develop by audit or under reporting form policies and renewal premiums on non-cancellable bonds, will be treated specially. Your duty to pay us such premiums will be satisfied if within 60 days after the billing date (in the case of additional premiums) or the renewal date (in the case of renewal premiums) you tell us in

writing that you haven't been able to collect such premiums. We, then, will be responsible for collecting the premium. You will not be paid a commission on any premium we collect.

3 All premiums, including return premiums, are our property. You will hold such premiums as trustee for us. This trust relationship and our ownership of the premiums will not be affected by our books showing a creditor-debt relationship, the payment of balances at stated periods or your retention of commissions. Unless we agree otherwise in writing, you must maintain premium monies in a separate bank account and not mingle such money with your own funds.

\* \* \*

a Commissions. As full compensation for your services under this Agreement, we will pay you a commission on business which you submit to us which we accept. You may deduct your commission from the premiums you collect from us. ...

Agency/Company Agreement, §§2(b), 3(a). (A. 9).

Tri-Town collected premiums from the Insurers' policyholders in May, 1986. On June 20, 1986, Tri-Town failed to turn over \$111,266.52 of the Insurers' premiums. (A. 5, at ¶¶ 13, 14). Further premium payments of \$42,974.48 and \$10,374.05 were due to be made to the Insurers by Tri-Town on July 20 and August 20, respectively. (A. 5, at ¶15).

On June 9, 1986, BNE closed Tri-Town's line of credit. The Insurers then learned from Tri-Town itself that BNE was seizing the Insurers' policyholders' premiums collected by Tri-Town which Tri-Town had deposited in its account in BNE. (A. 5, ¶8). The Insurers' counsel also learned that Tri-Town had

allowed BNE to setoff \$250,000 Tri-Town held in separate escrow account for the Insurers, arising from a federal lawsuit, Aetna Fire Underwriters Insurance Company, et al. v. Tri-Town Insurance Agency, et al., United States District Court, District of Massachusetts, No. 85-0118-F. (A. 14). Based on the foregoing information, the Insurers commenced the instant action.

SUMMARY OF ARGUMENT

First, the Insurers' contend that the Superior Court was not precluded by federal law from issuing a preliminary injunction in this action because the Insurers were not seeking relief as creditors of BNE. The United States Supreme Court's most recent opinion interpreting 12 U.S.C. §91 expressly rejected the argument made in by BNE in this appeal -- that a state court could not issue an injunction against a national bank -- holding that the statute only applied to actions for attachments by a bank's creditors. In the instant action, the Insurers' sought an injunction, not an attachment, and sought to restrain the BNE from seizing the Insurers' funds, not the BNE's own assets. Therefore, the Superior Court was not constrained by federal law from issuing the instant injunction. (infra, pp. 6-8).

Second, the Insurers' argue that there is a strong likelihood that they will prevail on the merits. The

law does not allow setoffs from a depositor's account where a bank has knowledge or notice that those funds are not the depositor's, and the Insurers contend that BNE possessed actual knowledge or notice that Tri-Town was the Insurers' fiduciary holding deposited funds as trustee. Alternatively, the Insurers claim that BNE knew from the nature of Tri-Town's business that the deposited funds might not be Tri-Town's property, giving rise to a duty of inquiry regarding the ownership of those funds before using them to setoff Tri-Town's indebtedness. Even assuming arguendo that BNE had neither actual knowledge, notice, or circumstantial knowledge, the Insurers would still prevail because Tri-Town had no rights in the premiums and could not therefore encumber them under the Uniform Commercial Code. Therefore, BNE's security interest was unenforceable and its setoff of Tri-Town's indebtedness wrongful. After a full hearing on the merits, a constructive trust would be an appropriate remedy to allow the Insurers' to recover its premiums wrongfully seized by BNE. (infra, pp. 8-30).

Third, irreparable harm would be caused to the Insurers if the preliminary injunction were not granted. The Insurers' would suffer a loss of rights that could not be vindicated after a full hearing because they would be relegated to the status of an ordinary creditor of Tri-Town. Tri-Town is insolvent

and does not have funds of its own sufficient to pay off its indebtedness to BNE, and for that reason BNE attempted to seize the Insurers' premiums while in Tri-Town's possession. The prospect that the Insurers would be paid their premiums to be remitted in the future was seriously jeopardized. Money damages after a full hearing would do the Insurers no good because they lose their status as owners of the premiums. (infra, pp. 30-32).

ARGUMENT AND AUTHORITY

**I. FEDERAL LAW ONLY PREVENTS PREJUDGMENT SEIZURE OF A NATIONAL BANK'S PROPERTY BY THAT BANK'S CREDITORS**

The Insurers' are not seeking relief as creditors of the bank, and therefore the Superior Court was not prohibited from granting the Insurers an injunction. The construction of 12 U.S.C. §91 offered by the BNE -- that absolutely no injunction can be issued against a national bank by a state court -- was considered by the Supreme Court and was expressly rejected. Third National Bank in Nashville v. Impac Limited, Inc., 432 U.S. 312, 97 S.Ct. 2307, 53 L.Ed.2d 368 (1977) (state court injunction against national bank permitted by mortgagor to restrain bank's foreclosure on mortgagor's loan).

The Court noted that there were at least three different interpretations of the federal statute, but held that the intent of the National Banking Act was that the statute apply only to prevent pre-judgment

attachment in state court actions by creditors to seize a bank's own property. Id. at 322-323, 97 S.Ct. at 2313-2314, 53 L.Ed. 2d at 376-377. The BNE's construction of the above statute was expressly rejected. The Court's reasoning in rejecting the BNE's construction was (1) that the prohibition on prejudgment writs was actually aimed at preventing preferences by creditors, (2) that at the time of the statute's passage attachments and executions were writs used by creditors to seize bank property, and (3) that there was no identifiable local or national interest which the construction of the statute's scope now proffered by the BNE would serve. Id.

The Insurers submit that this latest expression of the operation of 12 U.S.C. §91, by the Supreme Court of the United States, eclipses the holdings of the cases cited by the BNE, and that the cases cited by the BNE were nevertheless inapplicable to the instant action. The cases cited by BNE were actions against the bank seeking preliminary relief against the bank's own assets, not the funds of a bank depositor. In addition, each of the cited cases deals with attachments, not preliminary injunctions. Compare, Phelan v. Atlantic Nat. Bank of Boston, 301 Mass. 463 (1938) (action seeking attachment against national bank's property in hands of trustee); Pacific National Bank v. Mixer (cited by BNE as Butler v. Coleman), 124

U.S. 721, 8 S.Ct. 718, 31 L.Ed. 567 (1888) (attachment of bank's own property by creditor of bank), distinguished as not controlling issuance of injunctions by state courts in Third National Bank, supra at 318-320, 97 S.Ct. 2311-2312, 53 L.Ed.2d at 374-375, Chesapeake Bank v. First National Bank of Baltimore, 40 Md. 269 (1874) (attachment of bank's own property by bank's creditor).

**II. THERE IS A STRONG LIKELIHOOD THAT THE INSURERS WILL PREVAIL ON THE MERITS AND SUCCEED IN SHOWING THAT THE BNE'S SETOFF WAS WRONGFUL**

- a. The BNE could not setoff funds deposited in Tri-Town's account because the BNE had actual knowledge or notice that the funds were not Tri-Town's property

Where a bank has actual knowledge or notice that a depositor's funds are not the depositor's own, a bank may not use the funds to reduce the depositor's personal indebtedness. See TeSelle, Banker's Right of Setoff--Banker Beware, 34 Okla. L. Rev. 40, 44, n.20 (1981) ("rule is universal"); Annot., Bank's Right to Apply Third Person's Funds Deposited in Debtor's Name, on Debtor's Obligation, 8 A.L.R. 235, 239 (1966); Norton and Whitley, Banking Law Manual, §11.05(2), at 11-39 (Bender 1985).

The Insurers allege alternatively that (1) BNE had actual knowledge or notice that the funds deposited in Tri-Town's account were not its own, or (2) BNE knew or should have known that the deposited funds were not

Tri-Town's by BNE's knowledge of the nature of Tri-Town's business. Under either alternative, BNE was prohibited from seizing the Insurers' premiums and the injunction at issue here was properly issued.

The Insurers' claim of BNE's knowledge (actual, constructive, and circumstantial) that funds deposited in Tri-Town's account were not its own was based on the following facts:

First, merely the name on Tri-Town's account with BNE, "Tri-Town Insurance Agency, Inc.," gave BNE actual knowledge that Tri-Town was an insurance agent. It is generally known and the Superior Court implicitly acknowledged that insurance agents work for commissions, and that the premiums they collect are not entirely theirs but must be remitted to the company that actually accepts risks and pays losses.

Second, BNE had a copy of the Insurers' Agency/Company agreement which gave the BNE actual knowledge that Tri-Town was collecting premiums which belonged to the Insurers. The Insurers made a protective U.C.C. filing of a security agreement (with the Agency/Company agreement appended thereto) in March, 1985, covering Tri-Town's expirations (not in issue here). (A. 35). BNE is a large institution and undoubtedly, before it issued Tri-Town a \$2 million letter of credit on the September 20, 1985, BNE had a search conducted which included ascertaining the

Agency/Company agreement.

Third, as the Superior Court specifically found, the BNE had an awareness of the nature of the relationship between Tri-Town and the Insurers, where Tri-Town acted as the Insurers' collection agent and remitted premiums at stated times. The trade practice among insurance companies and the agents who sell their policies is that the agents collect premiums and remit them to the company. (A. 27).

Fourth, apart from any knowledge derived from the Agency/Company agreement undoubtedly in their possession, BNE must be charged with having taken care to ascertain the nature and sources of Tri-Town's income (commissions), before BNE's issuance of a \$2 million line of credit to Tri-Town. A bank exercising due care would obtain and examine Tri-Town's contracts with third parties before issuing such credit. The Superior Court would not have erred in assuming the BNE acted professionally (and not in breach of the duty of care it owed to its shareholders) in properly investigating Tri-Town's business before issuing credit, which investigation would surely have found the Agent/Company agreement and the usual premium remittance practice between Tri-Town and the Insurers.

Fifth, each month Tri-Town deposited hundreds of checks from the Insurers' policyholders, many of which contained a reference to the insurance purchased. BNE

must be charged with this information, and additionally the fluctuations in Tri-Town's account balance, which indicated that only a small percentage of monthly gross deposits were retained and the balance remitted to the Insurers and other insurance companies. Again, BNE's knowledge of the Insurers' claimed ownership of deposited funds would have been undisputable if BNE exercised proper banking practices before its issuance of Tri-Town's letter of credit.

Sixth, BNE admitted in its affidavit accompanying its opposition to the instant injunction that at least some of the premiums owed to the Insurers were not paid. (A. 17, at ¶¶ 2, 5). This demonstrates BNE's knowledge (a) on the nature of Tri-Town's business, (b) on the course of dealing between Tri-Town and the Insurers, and (c) that the Insurers had an interest in the deposited funds.

BNE should not be allowed to seize the Insurers' property while ignoring the obvious: that Tri-Town is an insurance agency, not an insurance company, and premiums Tri-Town collected and deposited were not its own. At the very least BNE had "inquiry notice" requiring it to ascertain whether Tri-Town's deposits were Tri-Town's own property. The fact that BNE had set up a mechanism to make "automatic reductions" from Tri-Town's account, without undertaking any act should be of no consequence. The substance of BNE's conduct

was to seize deposits of premiums from the Insurers' policyholders and set off those funds against Tri-Town's indebtedness.

Where a bank knows that a third person has an equitable interest in the funds in its debtor/depositor's account, the bank does not have the right to set off the deposited funds. Grant v. Colonial Bank & Trust Co., 356 Mass. 392 (1969) (bank with knowledge that escrow agent was holding trust funds for another prohibited bank from applying funds against depositor's indebtedness). See also, Dahlborg v. Middleborough Trust Co., 16 Mass. App. Ct. 481 (1983) (bank could not apply funds it knew were trust funds against trustee's personal indebtedness). Conversely, where a bank has no actual knowledge of a third party's interest, it may exercise any right to setoff it has to reduce the depositor's indebtedness to the bank. See Aetna Cas. & Sur. Co. v. Harvard Trust Co., 344 Mass. 160 (1962) (bank could retain money paid to by third party to debtor which debtor deposited in bank, where bank had no actual knowledge or notice of debtor's default); Wood v. Boylston Nat. Bank, 129 Mass. 358 (1880) (bank with no knowledge of fact that deposited note was property of another may properly apply the note toward the depositor's own indebtedness); School Dist. v. First Nat. Bank, 102 Mass. 174 (1869) (in the absence of any notice that

trustee's deposits in personal account were not trustee's own personal property, bank may apply deposited funds to trustee's personal indebtedness).

No Massachusetts case has directly considered the legal effect of a bank's right to setoff where the bank possessed less than actual knowledge of a third party's interest in deposited funds, such as notice or constructive knowledge of another's interest the bank's part. See Grant, 356 Mass. at 398, n. 9 (question whether bank has right to setoff in absence of (actual) knowledge left open). But see School Dist., supra (any notice to bank may be sufficient to prohibit setoff) (dictum). The above-cited cases each dealt with the legal effect of the presence or absence of a bank's actual knowledge that a third party's funds held by a debtor were its own. While the Insurers first contention is that BNE had actual knowledge and that the Insurers should prevail pursuant to Grant, supra, their second contention is that BNE's notice or constructive knowledge (not yet considered by the Massachusetts courts) would likewise be a sufficient basis to prohibit the BNE from exercising any right of setoff it possessed.

The Superior Court indicated in its original opinion, and reiterated in its opinion denying BNE's motion to stay the injunction, that the ultimate finding of the Insurers likelihood of prevailing on the

merits was based on the subsidiary finding of the relationship between the Insurers and Tri-Town, and the awareness of BNE of that relationship. (A. 27). The finding was based on the oral argument, affidavits, and pleadings. (A. 19). Accordingly, the Court's findings are entitled to at least some deference on appeal, especially due to the absence of a hearing transcript. M.R.Civ.P. 52(a) (findings shall not be set aside unless clearly erroneous); Larabee v. Potvin, 390 Mass. 636 (1983) (findings may not be disturbed unless plainly wrong).

- b. BNE could not setoff funds deposited in Tri-Town's account because BNE knew the nature of Tri-Town's business and thus had a duty to make inquiry of Tri-Town

BNE had knowledge of the nature of Tri-Town's business, that of an insurance agency, and had knowledge of the sources of Tri-Town's income. Each month hundreds of checks were deposited in Tri-Town's accounts for insurance written by Tri-Town and underwritten by the Insurers. Where a bank has notice of facts tending to indicate a third person's interest in funds sufficient to put it on inquiry as to the true character of a deposit, its right to set off is subject to the rights of such third party. In Re Milano Textiles, Inc., 38 B.R. 964, 967 (Bankr.D.Mass. 1984) (bank's knowledge and notice of facts sufficient to require inquiry before setoff shown by previous

agreement between bank and other creditors).

While Massachusetts case law prohibits a bank from setting off its depositor's debts from account funds where the bank has knowledge of the equitable interest in funds deposited in the debtor account, Grant, supra, no decided case has been held that circumstantial knowledge of a third party's interest was sufficient to extinguish the bank's right of setoff. But see Milano, supra. In this void, guidance may be derived from other jurisdictions' cases demonstrating the type of circumstantial knowledge and imputed notice necessary to preclude the exercise of a bank's setoff rights or to give rise to a pre-setoff duty of inquiry. In Central Nat. Bank v. Connecticut Mut. Ins. Co., 104 U.S. 54, 26 L.Ed. 693 (1881), it was sufficient circumstantial knowledge to prevent setoff of deposited premiums where the bank knew (1) that its depositor/debtor was the agent for an insurance company, (2) that it was the agent's business and duty to collect and remit premiums to the company, (3) that the account was used to deposit premiums awaiting transfer to the company, (4) that premiums paid to the company were derived from that account, and (5) that the premiums paid out were the bulk of funds deposited therein. Similarly, in Union Stock Yards Nat. Bank v. Gillispie, 137 U.S. 411, 34 L.Ed. 724, 11 S.Ct. 118 (1890), a bank's knowledge of the nature of its

depositor's business (commercial agent who sold cattle, title to which remained with his principal), in addition to bank's knowledge that the depositor's business was failing and of the depositor's overdrafts, were sufficient circumstances requiring inquiry of the ownership of deposited funds and prohibiting setoff. Id., at 416-418, 11 S.Ct. 120-121, 34 L.Ed. \_\_\_\_.

Even if BNE's circumstantial knowledge regarding Tri-Town's business affairs did not give rise to a duty of inquiry, BNE may still be prohibited from using the Insurers' premiums to set off Tri-Town's indebtedness where BNE's lack of knowledge did not result in any change in BNE's position and no superior equities have been raised in BNE's favor. National Indem. Co. v. Spring Branch State Bank, 162 Tex. 521, 348 S.W.2d 528 (1961); American Nat. Bank v. Nat. Indem. Co., 222 F.2d 513 (8th Cir. 1955). BNE did not change its position after seizing the Insurers' premiums and no superior equities have been raised in its favor.

- c. Tri-Town held the Insurers' policyholders' premiums it collected as the Insurers' fiduciary

BNE argues that the Insurers have merely a contractual right to be paid an amount equal to the amount of premiums collected by Tri-Town, and as such the Insurers are debtors of Tri-Town. The question of whether Tri-Town was the Insurers' fiduciary, holding the premiums in trust, or was merely Tri-Town's debtor

is fundamental to determining whether the premiums were Tri-Town's own or the Insurers' property.

A recent case is particularly instructive to whether premiums collected and deposited in agency accounts were the Tri-Town's own property or whether those funds were held as a fiduciary. Construing an Agency/Company agreement closely similar to the one at issue here, an insurance agency's payment of deposited premiums over to an insurer within 90 days of the filing of a bankruptcy petition was held not to be a preferential transfer voidable by the bankruptcy trustee. The holding of that case provided that the relationship between the agent and the company was a fiduciary trust relationship, and not of debtor-creditor. In Re Hughes & Assoc. Ins. Agency, Inc. v. General Accident Ins., 71 B.R. 92 (Bankr.S.D.Ind. 1987) (relying in part on Indiana law substantially similar to G.L. c. 175, §169, recognizing insurance agent, although possibly an independent contractor for other purposes, is special agent of insurance company for limited purpose of collecting insurance company's premiums).

The Supreme Judicial Court has likewise held a fiduciary relationship existed between an insurance company and an agency with respect to premiums collected by the agent pursuant to a trust agreement in Union Mut. Cas. Ins. Corp. v. Ins. Budget Plan, Inc.,

291 Mass. 62 (1935). In that case the agency/insurance company agreement, not unlike the one at issue here, stated "The monies and other properties received by the Agent for and on behalf of the Company shall be held by the Agent in a fiduciary capacity." Id. at 65.

BNE's reliance on Munro v. Bowers, 293 Mass. 514 (1936), attempting to show a debtor/creditor relationship between the Insurers and BNE is based on a misconception of the holding of that case. Munro is clearly distinguishable in that (1) the insurer was not a party to the action, (2) there was no trust agreement between the agent and the broker, and (3) any interest the insurer may have had in the premiums had already been satisfied by the agent. In fact the effect of the agency agreement between the general agent and the insurer in Munro was not discussed by the court except in passing. Id. at 516. Compare, In Re Katzen, 47 B.R. 738 (Bankr.D.Mass. 1985) (where no agency agreement stating intent to create trust, relationship was debtor/creditor); In Re Koritz, 2 B.R. 408 (Bankr.D.Mass. 1979) (no agency agreement, Koritz was never a broker, agent, or designated agent for insurer; no fiduciary relationship between Koritz and insurer).

Section 176 of G.L. c. 175, states:

An insurance agent ... who act in negotiating or renewing or continuing a policy of insurance ..., and who receives any money or substitute for money as a premium for such policy or contract from the insured ..., shall be deemed to hold such premium in trust

for the company. If he fails to pay the same over to the company after written demand upon him therefor, less his commissions ..., such failure shall be prima facie evidence that he has used or applied said premium for a purpose other than paying the same over to the company, and upon conviction thereof he shall be guilty of larceny.

The plain import of G.L. c. 175, §176, is that an insurance agent who receives premiums on behalf of an insurer and then fails to remit those premiums on demand is assumed to have committed larceny. Larceny is the trespassory taking and carrying away of the personal property of another with intent to steal. G.L. c. 266, §30(1). A defendant cannot commit a larceny unless the property he takes and carries away with intent to steal is not his own. See discussion in Commonwealth v. Souza, 397 Mass. 236, 241-242 (1986). Section 176 creates a trust relationship by law in cases such as this.

It would be an anomaly if premiums collected by an insurance agent were treated as the insurance company's property for the purpose of holding the agent criminally liable for larceny if the premiums were not remitted, but treated as if the premiums were the agent's property for determining if a bank has a contractual right to seize those premiums. The Insurers' submit that the BNE's argument that Tri-Town had rights in the net premiums resulting in an enforceable security agreement cannot withstand the plain import of G.L. c. 175, §176, which settles the

issue than an agent is a fiduciary, and not a debtor.

In Re Katzen, one of the cases relied upon by BNE, makes the existence of a fiduciary relationship hinge solely on whether the agency agreement required the agent to segregate and account for funds collected. While the Insurers do not suggest that the Katzen case is correct, its holding certainly would support the Insurers claim that Tri-Town was a fiduciary because of the provisions of the Agency/Company agreement, which imposes upon Tri-Town duties to maintain collected premiums in a separate account, not to commingle them with personal funds, and which gave the Insurers the right to an accounting. (A. 9, at §2(b)(3), §2(g)).

In sum, both the Agent/Company agreement and G.L. c. 175, §176, establish a trust relationship between an Tri-Town and the Insurers. The premiums which were deposited in Tri-Town's accounts were not from direct billing policies, but were from policies in which Tri-Town acted as the Insurers' special agent for purposes of collection pursuant to G.L. c. 175, §169. As such, the relationship between the Insurers and Tri-Town was one of trustee-beneficiary.

- d. Even assuming BNE had no actual knowledge or circumstantial knowledge that Tri-Town's deposited funds were not its own, BNE's security interest did not attach to the funds in Tri-Town's account because Tri-Town had no rights in those funds

Assuming arguendo that BNE had no actual knowledge, notice or circumstantial knowledge that the premiums deposited in Tri-Town's account were not Tri-Town's own, BNE's setoff was nevertheless wrongful. BNE had no right of setoff because Tri-Town had no rights in the collateral (deposited premiums), and thus the security interest never attached and became enforceable between BNE and Tri-Town, or as against third parties.

Section 9-203(1) of G.L. c. 106 provides that no security interest may attach until (1) there is an adequate security agreement, (2) the creditor gives value, and (3) the debtor has rights in the collateral. (emphasis added). Baystate Drywall, Inc. v. Chicopee Sav. Bank, 385 Mass. 17, 19-20 (1983). Only when the debtor has rights in the collateral may a security agreement become a security interest and enforceable between the debtor and creditor, and against third parties. BNE now claims that it was entitled, pursuant to its security agreement, to setoff funds in Tri-Town's account against Tri-Town's indebtedness.

The Insurers submit that BNE's use of the Insurers' funds (deposited in Tri-Town's account) to reduce Tri-Town's indebtedness to BNE was wrongful,

because Tri-Town never had rights in the collateral and thus no security interest attached. Baystate Drywall, supra. The rationale behind the requirement that a debtor must have rights in the collateral he seeks to encumber is elementary; a debtor can only encumber his own property, and cannot encumber property of someone else.

The totality of Tri-Town's rights in the hundreds of policyholders' checks deposited in its account each month consisted of the following; (1) the right to retain its commissions (approximately 15 percent of those gross deposits), and (2) the right to hold the premiums collected in its accounts as a fiduciary for more than 50 days until payable to the Insurers. (A. 9, at §2(g)(3)). The Insurers have never objected to BNE's seizure of Tri-Town's own property, that portion of the gross premiums deposited representing Tri-Town's earned commissions. However, Tri-Town's authority to hold the Insurers' policyholders' premiums in its account for 45 days after the end of the month in which the business was recorded on the Insurers' books did not give Tri-Town rights in those premiums. By statute, the Insurers could not require payment of premiums collected by Tri-Town to be paid over to the Insurers any earlier than 50 days from the policyholder's payment date. G.L. c. 175, §163 (ninth ¶).

The Massachusetts appellate courts have not had the opportunity to provide guidance upon what quality of ownership or possession a debtor must have such that he has "rights in the collateral". But see, Framingham U.A.W. Credit Union v. Pontiac Village, Inc., 41 Mass. App. Dec. 146, 150-152 (1969) (in contest between two creditors, each given purchase money security interests in same vehicle, second lender prevailed because debtor did not have any rights in vehicle at time of first lender's security interest). Pursuant to the contract between the Insurers and Tri-Town, Tri-Town was required to collect premiums, hold them as fiduciary, and pay them over to the Insurers. Tri-Town was permitted to retain its commissions out of the premiums collected. (A. 10, at §3(a)).

By the law of other jurisdictions, the debtor does not have "rights in the collateral" until he has possession of a greater quality than bare possession. In Cain v. County Club Delicatessen, 25 Conn. Supp. 327, 203 A.2d 441 (1964), it was held that a conditional buyer's possession of goods not yet covered by a conditional sales contract was insufficient to be considered "rights in the collateral" and thus no enforceable security interest attached. Similarly, in Weld Colorado Bank v. E & E Constr., Inc., 653 P.2d 758 (Colo. App. 1982), a security interest in the debtor's accounts receivable did not attach and become

enforceable because the debtor did not have a right to payment. Accord, Heinrichdorff v. Raat, 655 P.2d 860 (Colo. App. 1982) (no security interest in contractor's accounts because, by statute, contractor had no rights to payment until materialmen paid).

A case closely analogous to the instant one involved a travel agent, who, pursuant to an agency agreement between itself and an air carriers' consortium, sold airline tickets and collected payments which were then remitted to the consortium. The agent then began assigning its accounts receivable to a third party. When the agent went out of business, the third party staked its claim to the yet uncollected accounts by virtue of a financing statement filed pursuant to the Uniform Commercial Code. The consortium prevailed over the third party, as it was held that the agent possessed no rights in the accounts which could be assigned. The funds were at all times the consortium's property and while in the agent's hands were held as a trustee. Air Traffic Conf. v. Downtown Travel Center, 87 Misc.2d 151, 383 N.Y.S.2d 805 (1976). Similarly, a security agreement which covers after-acquired property would not attach and become enforceable against a third party's property which later came into the possession of the debtor. Compare, National Livestock Credit Corp. v. First State Bank, 503 P.2d 1283, 1285 (Okla. Ct. App. 1972) (debtor had no rights in cattle

purchased for another), with South Central Livestock Dealers, Inc. v. Security State Bank, 551 F.2d 1346, 1350 (5th Cir. 1977), aff'd, 614 F.2d 1056 (1980) (where bank aware depositor was feedlot operator working for commission and that depositor's funds were from sale of another's cattle, it could not apply such funds against depositor's indebtedness).

The instant case should be treated the same as a security interest created by a joint tenant. A joint tenant only has rights in an undivided one half of the jointly held property, and a security interest created by a joint tenant only affects that tenant's interest in the property. Motz v. Central Nat. Bank, 119 Ill.App.3d 601, 456 N.E.2d 958 (1983). Similarly, here Tri-Town only had rights in its commissions, so that would be all that Tri-Town could encumber and the commissions would be the only portion of the gross premiums collected which would be affected by BNE's security interest.

Possession for a limited purpose, such as the possession of a machine by a bailee to perform modifications and adjustments, was held not to amount to "rights in the collateral" in Chrysler Corp. v. Adamatic, Inc., 59 Wis.2d 219, 208 N.W.2d 97 (1973). Accord, Matter of Chicago, Madison & Northwestern Ry. Co., 36 B.R. 292, 298 (Bankr.D.Wis. 1984) (possession for repair). The possession by a bailee is comparable

to Tri-Town's holding of the net premiums in its account as a trustee. Likewise, a true consignment of goods to a seller, working on commission, leaves the seller with no rights in the goods which he may encumber. Manger v. Davis, 619 P.2d 687 (Utah 1980) (secured creditor's interest in diamond ring possessed and encumbered by gemologist who did not own the ring not enforceable).

Professors White and Summers state that where property is owned by a third party, mere acquisition of possession by the debtor does not give the debtor "rights" in that property. Where the debtor has less than full ownership, a security interest may attach to the extent of the debtor's rights. White and Summers, Uniform Commercial Code, §23-4, at 917 (2d Ed. 1980). This is consistent with the Insurers' claim herein, that BNE's security interest attached only to Tri-Town's commissions, the part of the policyholders' payments which Tri-Town had rights in, but not to the premiums which were the property of the Insurers.

Where a depositor does not have rights in the funds deposited in his account, then a bank is prohibited from using those funds to setoff the debtor's indebtedness. For example, In Re Property Leasing & Management, Inc., 46 B.R. 903 (Bankr.E.D.Tenn. 1985), concerned a rental agent who had an agreement with property owners that it would pay

the property owners their rents minus expenses and the agent's commission. The rental agent deposited the gross rents collected and the bank used those deposits. Upon a bankruptcy filing, the bank sought to set off amounts owed to the bank by the agent from the account containing the rents. The court held that the bank could only set off that portion of the rent deposits which the agent was not obligated to remit to the property owners. Id. at 910. The instant case is a factual parallel of Property Leasing, both in the agency agreement, agent's commingling of fiduciary and personal funds, and the rights which the agent possessed in the funds it held.

BNE stakes its claim to setoff Tri-Town's deposits by virtue of its security agreement with Tri-Town, which provided for a security interest in Tri-Town's accounts and allowed BNE the right to setoffs if Tri-Town defaulted. First, BNE admitted that it has not placed Tri-Town in default. (A. 16, at ¶4). Second, the Insurers submit that while security interests in accounts come into existence when the account is created, Tri-Town had no encumberable ownership rights in the accounts. An "account" is defined by the Uniform Commercial Code as "any right to payment ... for services rendered ..." G.L. c. 106, §9-106. The Agency Agreement clearly establishes that Tri-Town's commissions which it is permitted to retain out of

gross premiums collected comprised the totality of its compensation for its services rendered. (A. 9, at §3(a) ("Agent is authorized, ... [to sell insurance and collect premiums] ... and to retain out of premiums so collected and paid, as full compensation therefore, commissions..."). Therefore, BNE's security agreement creating a security agreement in Tri-Town's "accounts" would not include the net premiums which were the property of the Insurers and thus BNE's setoff was wrongful.

- e. The creation of a constructive trust is a viable theory upon which to recover deposits already seized by BNE

The Insurers' seek the creation of a constructive trust after a full hearing on the merits. While a constructive trust was not an issue relevant to the granting of the Insurers' preliminary injunction, the availability of such a remedy upon a full hearing demonstrates the Insurers' likelihood of success on the merits of this action, and is therefore presented here.

The creation of a constructive trust is a proper remedy to recover deposits belonging to the Insurers seized by the BNE from Tri-Town's account. A constructive trust was recognized as a proper remedy where a bank, which knew of a contractor's unstable financial condition, took the contractor's funds which were due to sub-contractors. The Appeals Court there stated:

The fiduciary duty we find imposed on the bank ... derives from the peculiar combination of circumstances in this case: the banks actions ... with knowledge of the contractor's weak financial condition; and its knowledge of the contractor's unpaid bills.

Superior Glass Co., Inc. v. First Bristol County National Bank, 8 Mass. App. Ct. 356, 362 (1979), Aff'd, 380 Mass. 829 (1980).

A constructive trust is an equitable device used to avoid unjust enrichment where property has been obtained by (1) fraud, (2) breach of fiduciary duty, or (3) wrongful use of confidential information. See Barry v. Covich, 322 Mass. 338 (1955). Recently, a constructive trust theory was successfully used to recover lost deposits where the bank had misrepresented its financial status, resulting in depositors' losses. Professional Asset Management v. Penn Square Bank, 55 U.S.L.W. 2369, 2 BNA Civ.Tr.Man. 591 (W.D.Okla. Dec. 15, 1986).

In the instant case BNE knew that Tri-Town was in a weak financial condition. By its own admission, BNE knew of the action against Tri-Town and its principals by the Division of Insurance seeking revocation of its agency license, of the death of Tri-Town's chief operating officer on April 16, 1986. BNE admitted that on June 9, 1986, it cut off Tri-Town's ability to further borrow on its line of credit. More generally, BNE admits it knew Tri-Town suffered from "several major reversals." Undoubtedly, BNE also knew of the

claim pending against Tri-Town, Aetna Fire Underwriters Insurance Company, et al. v. Tri-Town Insurance Agency, et al., United States District Court, District of Massachusetts, No. 85-0118-F, wherein Tri-Town was alleged to have sold in excess of \$1 million in horse mortality insurance policies without authorization.

BNE's conduct in alternatively knowingly taking the Insurers' premiums held in Tri-Town accounts, or taking such funds without making inquiry required by its circumstantial knowledge, provides sufficient facts upon which to base a claim for a constructive trust remedy.

**III. THE INSURERS WOULD SUFFER A LOSS OF RIGHTS WHICH COULD NOT BE VINDICATED LATER IF A PRELIMINARY INJUNCTION WERE NOT ISSUED**

It was foreseen by the Superior Court that irreparable harm would be caused to the Insurers if the preliminary injunction were not granted. The Insurers' could have been expected to suffer a loss of rights that could not be vindicated after a full hearing because they would be relegated to the status of an ordinary creditor of Tri-Town. Tri-Town was apparently insolvent and did not have funds of its own sufficient to pay off its indebtedness to BNE, and for that reason BNE had attempted to seize the Insurers' premiums while in Tri-Town's possession.

The harm the Insurers would suffer would not be capable of remediation because of Tri-Town's insolvency

and because without an injunction the premiums would be considered part of Tri-Town's property, making the Insurers creditors competing for their own disgorged property. As the Superior Court stated, "the risk of irreparable harm is greater to the plaintiff than the defendant because the likelihood of the plaintiff being able to recoup the money held by Tri-Town is no good unless protection is afforded to them." (A. 27) If no injunction was issued, the funds in Tri-Town's account would be quickly exhausted by BNE and no money would remain to pay the Insurers. BNE argues that it is a strong financial institution and that it could easily meet any judgment in favor of the Insurers, and in making that argument BNE demonstrates how, when balancing the equities, it could not be hurt by a wrongfully issued injunction. In contrast, the Insurers would suffer not only the unavailability of Tri-Town to answer for its non-remittance of premiums, but those funds would be considered Tri-Town's property and therefore could doubtfully be recouped from BNE.

Money damages after a full hearing would do the Insurers no good because they would lose their status as owners of the premiums. In part, the reason why this action was commenced was to prevent BNE from seizing future premium payments from Tri-Town, due July 20 and August 20, 1986. If the injunction was not issued those premiums would have been seized and not


recoverable by final judgment because the Insurers would already have been adjudged creditors. The premiums would fall into Tri-Town's "estate" and would probably not thereafter be recoverable as the Insurers' own property.

CONCLUSION

For the foregoing reasons, the Insurers respectfully request this Court to sustain the injunction issued by the Superior Court and remand this cause for full hearing on the merits.

AETNA FIRE UNDERWRITERS INSURANCE COMPANY, AETNA INSURANCE COMPANY, CIGNA INSURANCE COMPANY, INDEMNITY INSURANCE COMPANY OF NORTH AMERICA, and PACIFIC EMPLOYERS INSURANCE COMPANY, Plaintiffs-Appellees

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