The New Restatement of Restitution and the UCC: “Supplementary General Principles of Law Applicable”

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OUTLINE OF PROFESSOR KULL’S REMARKS

I. Introducing Restatement Third, Restitution and Unjust Enrichment:

• What happened to the old Restatement?
• What is “restitution,” anyway?
• The scope of the subject as reflected in its projected Table of Contents.
• Restitution as the repository of Equity?

II. Restitution vs. Statute (in Broad Outline)

A. Traditional illustrations: Statute of Frauds, statute of limitations.


C. The UCC:

• Equitable considerations may concededly be “displaced” (§ 1-103), and sometimes clearly have been:
  o “Pure race” priority (§ 9-317(a)(2)).
  o “A transferee of money takes the money free of a security interest unless the transferee acts in collusion with the debtor in violating the rights of the secured party” (§ 9-332(a)), with the result that the payee is protected even if he has knowledge (let alone notice) that payment is wrongful.

• Otherwise, “Supplemental Principles of General Law Applicable,” with perhaps 50% of the background rules there mentioned being part of the law of “restitution.”

• The receding background:
  o the FRCP and the law schools
  o law written by lawyers for lawyers?
III. Does the UCC Bar Relief from Mistake?

A. Traditional equity in a real-property context:

- Reformation of a deed: R3RUE § 12, Ills. 4-5.
- Mistaken cancellation: R3RUE § 7(2), Ills. 18-19.
- Mistake as to intervening interests, subrogation: R3RUE § 8(2), Ills. 8-9.

B. Equity vs. “uncertainty” under the UCC, three examples

- Mistaken payment under § 3-418. See R3RUE § 6(2), Ill. 32; Morgan Guaranty Trust Co. v. Amer. Savings & Loan Ass’n, 804 F.2d 1487 (9th Cir. 1986).


UNIFORM COMMERCIAL CODE

(pre-2001)

§ 1-103. Supplementary General Principles of Law Applicable.

Unless displaced by the particular provisions of this chapter, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

(post-2001)

§ 1-103. * * * Applicability of Supplemental Principles of Law.

* * *

(b) Unless displaced by the particular provisions of [the Uniform Commercial Code, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause supplement its provisions.

(emphasis added)
PART I – Introduction

Chapter 1. General Principles
§ 1. Restitution and unjust enrichment.
§ 2. Liability for some benefits and not others.
§ 3. No profit from conscious wrongdoing.
§ 4. Restitution may be legal or equitable.

PART II – Liability in Restitution

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§ 7. Performance or discharge of another’s obligation.
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Chapter 3. Intentional Transactions

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§ 21. Protection of another’s property.
§ 22. Performance of another’s duty.

Topic 2. Self-interested intervention

§ 24. Protection of claimant’s property.
§ 25. [Former § 25 appears at § 46A.]
§ 26. [Former § 26 appears at § 46B.]
§ 27. Frustrated expectation of ownership.
§ 28. Unmarried cohabitants.
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§ 66. Bona fide purchaser.
§ 67. Bona fide creditor.
§ 68. Notice.
§ 69. Value.
§ 70. Limitation of actions; laches.
§ 6. Payment of money not due.

***(2) Payment of money resulting from a mistake by the payor as to the existence or extent of the payor’s obligation to an intended recipient gives the payor a claim in restitution against the recipient to the extent the payment was not due.***

Illustration:

***(a) A pays an obligation to B. Forgetting the earlier payment, A pays B a second time. A has a claim in restitution to recover the overpayment.***

Comment:

***(e) Voluntary payment. The restitution claim to recover a payment in excess of an underlying liability—a claim that is frequently described in terms of mistaken payment—meets an important limitation in the so-called voluntary payment rule. The rule appears in frequent judicial statements to the effect that “money voluntarily paid with knowledge of the facts cannot be recovered back.” Statements of this kind must be treated with caution. In a business setting, it is at least paradoxical to suppose that the overpayment of an asserted (or any payment of a nonexistent) liability could ever be “voluntary,” and it is important to bear in mind that the proper operation of the voluntary payment rule must be realistic rather than artificial. The rule does not, for example, impute knowledge of relevant circumstances of which the payor is not in fact aware, describing as “voluntary” a payment that was actually the consequence of negligence or inadvertence. When properly employed, a reference to “voluntary payment” is judicial shorthand for a truth of common experience: that a person must often choose to act on the basis of imperfect knowledge, accepting the risk that further information (acquired with the benefit of hindsight) may reveal the choice to have been less than optimal. A more appropriate statement of the voluntary payment rule, therefore, is that money voluntarily paid in the face of a recognized uncertainty as to the existence or extent of the payor’s obligation to the recipient may not be recovered, on the ground of “mistake,” merely because the payment is subsequently revealed to have exceeded the true amount of the underlying obligation.

Because a payor in a business setting will not gratuitously assume the risk of a recognized uncertainty as to either the fact or extent of its liability, a “voluntary” overpayment within the
meaning of the voluntary payment rule will normally occur in the context of a payment made to settle a claim. Where the terms of settlement involve an explicit compromise of an uncertain liability, the contractual mechanism by which a risk of uncertainty is allocated to the payor is relatively easy to see. But there may be settlement even in the absence of compromise. If a disputed claim is paid in full, notwithstanding a recognized uncertainty as to the existence or extent of the payor’s liability, the payor has typically made a conscious decision that the anticipated cost of resisting the claim exceeds the amount of the demand. Payment under these circumstances is “voluntary” to the extent that the settlement is voluntary.

* * *

Illustration:

18. B demands that A pay a debt, the amount of which is disputed. A claims credit for prior payments that B denies having received. Both parties are acting in good faith. When A is unable to prove the state of the account, A pays the amount demanded, despite his belief that the true amount of the debt is less than B’s demand. Later discovering B’s receipt for the prior payments, A sues B in restitution to recover the overpayment on the ground of mistake. A is not entitled to restitution, because (absent a showing of duress on the part of B) A’s payment to B is voluntary within the meaning of the voluntary payment rule. Payment of an account that is disputed in good faith ordinarily gives rise to a settlement, express or implied, and to an enforceable accord, allocating to the payor the risk of overpayment. Even if A acted unilaterally, he assumed the risk of overpayment by making the payment in the face of a recognized uncertainty as to the amount of liability. See § 5(3). B’s (implicit) threat to enforce A’s debt by civil process will not--without more--be held to constitute duress. See § 14, Comment g.

h. Negotiable instruments. The law of negotiable instruments confronts significant, recurring instances of the payment of money not due: familiar examples include a bank’s payment of a check drawn against insufficient funds, or in the absence of a necessary endorsement, or in disregard of the customer’s order to stop payment. Such transactions were treated at common law as problems of restitution for mistaken payments. Although the issues presented are, in a sense, as much a part of the law of restitution as they ever were, their traditional common-law formulation has been largely displaced by the applicable provisions of the Uniform Commercial Code.

A restitution analysis of these problems remains relevant, however, because the U.C.C. provisions on mistaken payments are only a partial codification, without material alteration, of the common law of restitution. Some important instances of a former liability in restitution have been recast as a liability based on implied warranty, though without altering the fundamental allocation of risks between the parties. See U.C.C. §§ 3-417, 4-208 (1990) (statutory warranty permits recovery of payment made by mistake to a person not entitled to enforce the instrument). Other Code provisions simply state, without alteration, a familiar rule of restitution. See U.C.C. § 3-418(a) & (c) (1990) (codifying the mistaken payor’s claim in restitution in two important instances, together with the most significant of the payee’s affirmative defenses). Still other Code provisions incorporate by reference the applicable law of restitution to govern those cases of mistaken payments for which the Code states no specific rule. See U.C.C. §§ 1-103, 3-418(b) (1990) (supplemental general principles of law applicable; law of “mistake and restitution” governs mistaken payment of instruments in circumstances not specifically addressed). Within this last class of cases, the payor’s claim to restitution is necessarily governed by the rules of this Section. See Illustrations 30-32. * * *
Illustration:

32. A’s promissory note is held by B. The note is payable at C Bank. Before the maturity of the note, A enters bankruptcy. B is aware of A’s bankruptcy and does not expect that the note will be paid. At the due date, however, B’s agent presents the note to C for payment. Although C has determined that it will make no further payment of A’s notes, the note presented on behalf of B is paid by mistake. C has a claim in restitution against B to recover the mistaken payment. B’s knowledge of A’s bankruptcy deprives B of the affirmative defenses it might otherwise have asserted.

§ 7. Performance or discharge of another’s obligation.

* * *

(2) Mistaken discharge by a creditor of a debtor’s obligation or the security therefor gives the creditor a claim in restitution by reinstatement of the rights mistakenly discharged.

Comment:

* * *

e. Discharge and cancellation. Like the mistaken performance of another’s obligation to a third party, the mistaken discharge by the obligee of an obligation or the security therefor gives rise to a claim in restitution against the mistakenly discharged obligor to the extent of the benefit conferred. Where the obligation is unliquidated, a discharge will ordinarily be effected by contractual means, such as a release, an accord, or an agreement of rescission. By contrast, a liquidated obligation that is represented by an instrument, such as a promissory note, lends itself to discharge by the unilateral act of the obligee in cancelling the instrument. Discharge, by cancellation or otherwise, is effective to alter legal obligations only when it is voluntary. See U.C.C. § 3-604(a) (1990). Mistaken discharge, effected by noncontractual means, presents a problem in restitution.

Mistaken discharge of an obligation or a security interest is usually remedied by treating the discharge as ineffective. The remedy is occasionally described by saying that the act of discharge is cancelled; or that the claimant is subrogated to the obligation or security that has been mistakenly discharged. The significance of such language is essentially that restitution revives the former obligation instead of creating a new one. The remedy thus preserves for the claimant the benefit of any security or priority attached to the former obligation, while preventing the unjustified enrichment of rival creditors whose claims would be advanced if such security or priority were lost in consequence of the claimant’s mistake. By the same token, the obligor will not be subjected to any new or enlarged obligation, such as the commencement of a new limitations period, as a result of the claimant’s mistake.

Illustrations:

18. A’s real property is mortgaged to B as security for a promissory note. A requests B to make a “payoff demand” for full satisfaction of the debt and release of the mortgage. Upon A’s payment of the amount requested, B surrenders the note and releases the mortgage. B later discovers that its
payoff letter understated the amount of A’s debt by $50,000. In some jurisdictions, B will be entitled to have the mortgage reinstated. Even if reinstatement of the mortgage is unavailable (for example, because of the effect of an antideficiency statute), B has a claim in restitution against A to the extent of the benefit conferred. In an antideficiency jurisdiction, this standard qualification of any restitution claim will limit B’s aggregate recovery to the fair market value of the property at the time the mortgage was released.

19. A borrows from B Bank, giving a note secured by a first mortgage on Blackacre. A thereafter sells Blackacre to C, subject to the A mortgage. C does not assume liability on A’s note. Some months later, B releases the mortgage on Blackacre, returning the mortgage instruments with satisfaction to C. A’s note has not been paid, and the release of the mortgage was the result of a clerical error on the part of B. C later sells Blackacre to D, a bona fide purchaser. B has no remedy against D, but B is entitled to a security interest in the sale proceeds realized by C. Relief may be structured without prejudice to C by giving B an equitable lien on terms that parallel the A mortgage.

§ 8. Payment in discharge of lien.

(1) A person whose payment in discharge of a lien confers an unintended benefit on another, as a result of the payor’s mistake about the ownership of the encumbered property, the existence of intervening interests, or other relevant circumstances, may be subrogated to the discharged lien as necessary to prevent the unjust enrichment of the other.

(2) A person who advances funds that are used to discharge a lien on property of another, acting in the reasonable expectation of receiving either the unencumbered property or a lien of equal priority, and who fails to receive the expected return because of a mistake about intervening interests or other relevant circumstances, may be subrogated to the discharged lien as necessary to prevent unjust enrichment.

Comments.

* * *

b. Third parties protected. Relief for mistake under the rules of this Section, even when it takes the paradoxical form of “subrogation to a discharged lien,” does not impair the rights of third parties, nor does it conflict with the policies underlying the protection of subsequent purchasers. Reinstatement of a lien discharged by mistake does not create a new interest in violation of the priorities established by the local recording act or by Article 9 of the Uniform Commercial Code. Rather it restores the previously existing priorities as the interested parties understood them to be, and as they would have remained but for the claimant’s mistake. Buyers or secured parties whose interests attach during the interval between the mistaken discharge of a prior lien and its reinstatement are protected by the affirmative defense of bona fide purchase. See § 70. The result in a particular case may be that a remedy under this Section is available against some competing lienors but not others.

* * *
e. Mistake as to intervening interests. Numerous decisions in a wide variety of factual settings allow restitution via subrogation to a party that has advanced money to discharge a lien on another’s property, acting under a mistaken belief about the existence of intervening interests. The essential contest in such cases is between the restitution claimant and competing lienors whose security would be advanced if restitution were denied. Subrogation is freely available insofar as its effect is merely to confirm such third parties in their preexisting priority, preventing their unjust enrichment in consequence of the claimant’s mistake. To the extent that subrogation would prejudice the interests of any third party, restitution will be limited or denied. For example, a refinancing lender whose new loan exceeds the balance due under the mistakenly discharged first mortgage will be subrogated only to the extent of that remaining balance. See Illustration 9. * * *

Illustrations:

8. A borrows from B, giving a promissory note secured by a first mortgage on Blackacre. C lends A $100,000 to pay the balance due on the note and discharge the mortgage, taking in return a new note and mortgage in the same amount. Unknown to C, Blackacre has previously become subject to a lien, duly recorded and second in priority to B’s mortgage, securing a judgment against A in favor of D. To prevent the unjust enrichment of D at the expense of C, C is subrogated to the rights of B, leaving D’s lien in its preexisting priority.

9. Same facts as Illustration 8, except that the outstanding amount of A’s obligation to B is $50,000, and C makes a refinancing loan in the amount of $100,000. C is subrogated to B’s first-position mortgage only to the extent of $50,000. The remaining $50,000 of A’s debt to C is secured by a third-position mortgage, junior to D’s lien.

**

f. Subrogation under U.C.C. Article 9. The rule of this Section applies without distinction to security interests in real and personal property. It is uniformly held that Article 9 of the Uniform Commercial Code does not displace the equitable doctrine of subrogation. Accordingly, a party who has failed by reason of mistake to obtain an intended security interest under Article 9, and whose discharge of a preexisting security interest would otherwise result in a windfall to rival creditors, will sometimes be permitted to avoid this result by means of a claim under this Section. The object of subrogation in such circumstances is to confirm the relative priorities of competing creditors as they were understood and intended to be established by the interested parties. See Illustrations 13-14. Third parties are protected against prejudice by the standard affirmative defenses. See Comment b.

13. Owner borrows $5,000 successively from each of A, B, and C, giving each a security interest in the same automobile. The three security interests are properly perfected in that order. C’s loan to Owner is made for the purpose of refinancing Owner’s debt to A and discharging A’s lien, and the funds are in fact so applied. C is unaware of B’s intervening interest and believes that its new lien has first priority. Owner defaults; the proceeds from the sale of the collateral are $8,000. C is entitled to $5,000 of the sale proceeds, via subrogation to A’s first-priority lien.

14. Owner borrows from A Bank, giving a first-priority security interest in accounts receivable and inventory. Owner’s indebtedness to A is thereafter refinanced with B Bank. Although the parties intend that the new loan from B benefit from the same security as the old loan from A, the necessary financing statements are never executed or filed; nor is A’s security interest ever released
of record. On Owner’s default, B may be subrogated to the security interest in favor of A that B’s funds were used to discharge. It is a condition of such relief that subsequent creditors not have changed position in the belief that Owner’s accounts and inventory were unencumbered. The fact that the records of the recording office continued to reflect an apparent security interest in favor of A, after A’s lien had in fact been discharged, may facilitate the court’s determination that relief via subrogation will not prejudice third parties.

Reporters’ Notes:

* * *


Equitable subrogation is part of the “background” commercial law incorporated by § 1-103 of the Uniform Commercial Code: “Unless displaced by the particular provisions of this Act, the principles of law and equity . . . shall supplement its provisions.” That being so, the critical determination is that “No provision of the [Uniform Commercial] Code purports to affect the fundamental equitable doctrine of subrogation.” French Lumber Co., supra, 346 Mass. at 719, 195 N.E.2d at 510. More specifically: “Rights of subrogation, although growing out of a contractual setting and oftentimes articulated by the contract, do not depend for their existence on a grant in the contract, but are created by law to avoid injustice. Therefore, subrogation rights are not ‘security interests’ within the meaning of Article 9.” Jacobs v. Northeastern Corp., 416 Pa. 417, 429, 206 A.2d 49, 55 (1965).


§ 12. Mistake in expression.

(1) If an instrument is intended to transfer an interest in property or to embody one party’s obligations to another, pursuant to agreement between them; and

(2) by a mistake as to its contents or legal effect, the instrument fails to reflect the agreement; and
(3) performance or enforcement of the underlying transaction in accordance with the terms of the instrument has resulted or would result in the unjust enrichment of one person at the expense of another; then

(4) the person disadvantaged by the mistake has a claim in restitution as necessary to prevent the unjust enrichment of the other.

Illustrations:

* * *

4. A sells Blackacre to B, reserving an easement. The deed prepared by A’s attorney fails to refer to the easement. Subject to the rights of third parties, A is entitled to reformation of the deed to conform to the parties’ agreement.

5. A sells B an interest in certain oil and gas leases insofar as they relate to one specific well. By a mistake in description, the instrument of assignment recorded by the county clerk purports to transfer A’s interest in three additional wells. A has a claim in restitution as necessary to prevent B’s unjust enrichment. Relief will include (i) the recovery of any royalties paid to B in respect of A’s leases, and (ii) subject to the rights of third parties, reformation of the assignment to conform to the parties’ agreement.

* * *

8. Lender agrees to refinance Borrower’s outstanding indebtedness of $100,000,000, for which Lender holds first-mortgage security. As the result of a typographical error, the instruments prepared to record Lender’s new mortgage describe the secured indebtedness as $100,000. Borrower defaults. When Lender attempts to foreclose its mortgage, Borrower’s junior lienors object that Lender’s first mortgage should be enforceable only to the extent of $100,000. Lender has a claim in restitution as necessary to prevent the unjust enrichment of Borrower’s junior lienors. Subject to the rights of third parties, the court will reform the mortgage instruments to conform to the parties’ agreement.

§ 13. Fraud and misrepresentation: rescission.

(1) A transfer induced by fraud or by an innocent, material misrepresentation is subject to rescission at the instance of the transferor or a successor in interest. Rescission under this Section includes a claim to the recovery of benefits conferred.

(2) If the nature of the fraud is such that the transferor had neither knowledge of, nor reasonable opportunity to learn, the character of the resulting transfer or its essential terms, the attempted transfer is void. Any other transfer within subsection (1) confers voidable title on the transferee.
Comment:

* * *

g. Fraud by third party. * * * Claims between banks in the aftermath of a check-kiting scheme may be viewed as attempts to recover payments made by mistake, or payments induced by the fraud of a third party. See Illustration 14. Such claims are decided, not by the Uniform Commercial Code, but by general principles of restitution. See U.C.C. § 3-418, Comment 3. Characterizing the transaction as a mistaken payment may be unsatisfactory, given that the payor/claimant is necessarily aware that it is honoring a draft on uncollected funds. On the other hand, the payor’s decision to do so is plainly influenced by the fraud of a third party, its customer. So long as the both payor and payee bank are unaware of their customer’s deception, restitution of any given payment will be foreclosed by the recipient’s status as bona fide creditor. See § 71. As in Illustration 14, however, the restitution claim will ordinarily attempt to recover only the last payments in the sequence: those made when the recipient had become aware of the fraud and the payor had not. Under such circumstances, the payee bank cannot claim to have received the funds as a bona fide creditor.

Substantial reasons of policy nevertheless support a rule that denies restitution between banks victimized by a check-kiting scheme, so long as the bank obtaining payment has not done so by means of fraudulent misrepresentations to the payor. If restitution is denied, the rationale consistent with the principles of this Section is that the decision to pay checks drawn against uncollected funds—an indispensable element of any check-kiting scheme—is primarily a credit decision on the part of the payor. The payor bank in such circumstances assumes the risk of noncollection and, to that extent, extends credit to its customer. If it is appropriate for policy reasons to regard this credit decision as the primary cause of the payor’s loss, the court might conclude that the payor bank should bear the losses to which its business practices make it subject.

Illustration:

14. Bank A and Bank B are victims of a check-kiting scheme operated by C. A (having detected the fraud) obtains payment of a final batch of checks drawn by C on B and deposited with A, while dishonoring at the last possible moment other checks drawn by C on A and presented by B. Although B is still unaware of C’s fraudulent scheme, B is necessarily aware that it is paying checks drawn by C against uncollected funds. B has a potential claim in restitution against A, based either on mistaken payment (§ 6) or on the fraud of C within the rule of this Section. A’s knowledge of C’s fraud, at the time of B’s payment, precludes the assertion by A of the usual affirmative defenses to B’s restitution claim. Restitution may nevertheless be denied if the court concludes (i) that A’s conduct was not fraudulent toward B, and (ii) that in electing to pay checks drawn against uncollected funds, B should be treated as assuming the risk of noncollection.

§ 17. Lack of Authority

A transfer by an agent, trustee, or other fiduciary outside the scope of the transferor’s authority, or otherwise in breach of the transferor’s duty to the principal or beneficiary, is subject to rescission and restitution at the instance of the principal, the beneficiary, or a successor in interest.
Comment:

* * *

d.  Creditor or purchaser with notice.  A claim under this Section is available against a creditor of the transferor, or a purchaser for value, if the transferee took the property with notice of the transferor’s breach of duty.  Notice on the part of the transferee may take the form of direct awareness of the transferor’s misfeasance.  See Illustrations 9-12.  Frequently, however, notice of the breach of duty will be constructive, as where (i) the transferee has notice that the transferor occupies a fiduciary relation to the beneficiary, and (ii) the circumstances of the transaction are such as to suggest that the transferor may be using the property of the beneficiary for personal gain.  See Illustrations 13-14.  On the elements of notice in such circumstances, see § 70, Comment __.  [Pending a draft of § 70, see Restatement of Restitution § 174; Restatement, Second, Trusts § 297; Restatement Third, Agency § 1.04, Comment e (Tentative Draft No. 2, 2001); Uniform Commercial Code §§ 1-201(25), 3-307 (1990).]

Illustrations:

9.  Owner transfers $100,000 to Contractor, who is acting for this purpose as Owner’s agent, to be forwarded to Supplier in payment for materials.  Contractor instead transfers $75,000 of Owner’s funds to Lender in satisfaction of Contractor’s personal indebtedness.  Lender is aware of the source of the payment: Contractor’s debt was overdue, and Contractor obtained Lender’s forbearance by promising to pay with Owner’s expected payment to Supplier.  Contractor is now insolvent.  Owner has a claim in restitution to recover $75,000 from Lender.  Lender’s defense as bona fide creditor (§ 68) is foreclosed by Lender’s knowledge of Contractor’s breach of duty.

10.  Trustee remits trust funds to Broker in payment for securities purchased in violation of the terms of the trust.  Broker has actual knowledge of Trustee’s lack of authority.  The unauthorized investment declines sharply in value.  A successor trustee has a claim against Broker under this Section to rescind the sale and recover the purchase price.

11.  A and B form a joint venture for the purchase and subdivision of Blackacre, A taking legal title to the property for the benefit of the partners.  In violation of the terms of the joint venture agreement, A conveys Blackacre to C for $50,000 paid to A personally.  C’s defense as bona fide purchaser (§ 67) is foreclosed by C’s knowledge, at the time of the transaction, of the terms of the agreement between A and B.  On suit by B, C will be required to hold Blackacre on constructive trust for the benefit of A and B, and to account to them for interim rents and other profits.

12.  Trustee draws $100,000 in trust funds, held by Bank in a trust account, applying $75,000 to discharge a liability of the trust to Bank and $25,000 to the payment of Trustee’s personal indebtedness to Bank.  A successor trustee has a claim under this Section to recover $25,000 from Bank for the benefit of the trust.  Bank’s affirmative defense as a bona fide creditor (§ 68) is foreclosed by its notice of Trustee’s breach of trust.

13.  Acting without authority, Treasurer pays a personal debt to Bank with a valid check drawn by Treasurer on Corporation’s account with Bank and payable to Bank.  Corporation has a claim under this Section to recover the money from Bank.  Bank’s affirmative defense as bona fide creditor (§ 68) is foreclosed by its notice of Treasurer’s breach of duty.  See U.C.C. § 3-307.
§ 31. Indefiniteness or lack of formality.

(1) Except as stated in subsection (3), a person who renders performance under an agreement that is unenforceable by the claimant (notwithstanding such performance) by reason of

(a) indefiniteness, or

(b) the failure to satisfy an extrinsic requirement of enforceability such as the Statute of Frauds,

has a claim in restitution against the recipient as necessary to prevent unjust enrichment. There is no unjust enrichment if the claimant receives the counterperformance specified by the parties’ unenforceable agreement. * * *

Comment:

* * *

g. Other laws requiring a writing. Besides the common provisions of the Statute of Frauds, the laws of most U.S. jurisdictions contain a variety of additional statutes or regulations--more recently enacted, and more precisely targeted--providing that agreements governing particular types of transaction are unenforceable unless evidenced by a signed writing. * * *

By comparison with the claimant whose oral contract is within the traditional Statute of Frauds, however, the claimant whose contract is made unenforceable by a modern regulatory statute is much more likely to encounter the objection that restitution is either prohibited by the statute in question or inimical to the policy behind it. Some modern legislation within this category may be fairly construed to prohibit not only enforcement of the unwritten contract but also restitution for benefits conferred thereunder. More often, a court will have to decide whether the allowance of restitution would weaken the protection intended to be afforded by a statute or regulation that (by its terms) prohibits only enforcement. * * *

So if a statute enacted in response to perceived abuses provides that a contract for home improvement “shall be in writing” and that an oral contract for such services is “void,” a court must decide whether the efficient pursuit of the evident legislative objective--the protection of vulnerable buyers against opportunistic sellers--also requires it, when the occasion arises, to protect opportunistic buyers against vulnerable sellers. * * *

Illustration:

* * *

16. Builder installs vinyl siding by agreement with Homeowner for a contract price of $5,000. After the work has been performed as requested, Homeowner refuses to pay. The written agreement of the parties fails to contain a clause, required by state law in transactions of this kind, reciting certain rights of Homeowner under local consumer-protection law. The statute requiring the inclusion of this language in the parties’ contract provides that a nonconforming contract shall
be “unenforceable and void.” Conceding the unenforceability of their agreement, Builder sues Homeowner in restitution. The court makes factual findings to the effect that (i) the reasonable value of the work performed was $5,000; (ii) the omission of the requisite contract language was unintentional on Builder’s part and resulted in no prejudice to Homeowner; and (iii) Homeowner expressed no dissatisfaction with Builder’s work until weeks after the job was completed, by which time his payment obligation was in default. The question to be decided, on these facts, is whether the statute should be construed to require forfeiture by Builder and the consequent unjust enrichment of Homeowner. If not, Builder may recover $5,000 from Homeowner under the rule of this Section.

§ 36. Restitution to a party in default.

(a) A party whose incomplete or defective performance prevents a recovery on the contract has a claim in restitution against the recipient as necessary to prevent unjust enrichment, not exceeding the net benefit thereby conferred.

(b) Net benefit to the recipient is measured by comparison to the recipient’s position had the contract been fully performed. The claimant has the burden of establishing the fact and the amount of the net benefit conferred. A remedy in restitution that subjects the recipient to a forced exchange will be qualified or limited to avoid undue prejudice to the recipient.

(c) A claim under this Section is subject to any valid agreement of the parties establishing their rights and remedies in the event of default.

(d) If the claimant’s default involves fraud or other inequitable conduct, restitution may on that account be denied (§ 62).

Comment:

* * *

12. Grower sells to Canner his entire crop of tomatoes for the coming season at a price of $300 per ton, payment to be made at the end of the season. On August 15, when the market price is $250 per ton, Grower harvests 20 tons of tomatoes and delivers them to Canner. On September 15, when the market price is $350, Grower harvests his remaining 20 tons and sells them to a third party. Grower demands payment from Canner of $5,000 (representing the initial delivery of 20 tons at the contract rate, less $1,000 market damages on account of the tomatoes sold elsewhere). If the relevant provisions of the Uniform Commercial Code are interpreted in light of the principles of restitution and unjust enrichment (U.C.C. § 1-103(b) (2002)), Grower will not be permitted to recover at the contract rate for his intentionally defaulted performance. Grower’s recovery by the rule of this Section is limited to $4,000 (representing the market value of Grower’s part performance, less $1,000 damages).
§ 39. Profit derived from opportunistic breach.

(1) If a breach of contract is both material and opportunistic, the injured promisee has a claim in restitution to the profit realized by the defaulting promisor as a result of the breach. Liability in restitution with disgorgement of profit is an alternative to liability for contract damages measured by injury to the promisee.

(2) A breach is “opportunistic” if

(a) the breach is deliberate;

(b) the breach is profitable by the test of subsection (3); and

(c) the promisee’s right to recover damages for the breach affords inadequate protection to the promisee’s contractual entitlement. In determining the adequacy of damages for this purpose,

(i) damages are ordinarily an adequate remedy if they can be used to acquire a full equivalent to the promised performance in a substitute transaction; and

(ii) damages are ordinarily an inadequate remedy if they cannot be used to acquire a full equivalent to the promised performance in a substitute transaction.

(3) A breach is “profitable” when it results in gains to the defaulting promisor (net of potential liability in damages) greater than the promisor would have realized from performance of the contract. * * *

§ 48. Payment to which claimant is otherwise entitled.

The recipient of a payment to which the claimant has a superior legal or equitable entitlement is liable to the claimant for the amount of the payment so received.

Illustrations:

* **

19. Farmer grows corn on land leased from Landlord. Farmer’s operations are financed by Bank, which holds a perfected security interest in Farmer’s growing crops and their proceeds. By statute, Landlord has a lien on the products of the leased acreage securing Farmer’s obligation to pay rent. The statute provides that a crop lien of the kind held by Landlord is not a “security interest” within the scope of the local version of UCC Article 9 and that it is “paramount to all other liens or claims” upon such products and their proceeds. Farmer sells his corn crop to Elevator for $25,000. Elevator pays farmer with a check payable to Farmer and Bank jointly; Farmer endorses the check,
and Bank applies the proceeds against Farmer’s outstanding debt to Bank. When Bank obtains payment of the check, Bank is aware that Farmer owes Landlord $15,000 in rent that was due on sale of the crop. Landlord is entitled to recover $15,000 from Bank by the rule of this Section. As between the competing obligees (Landlord and Bank), the priority of Landlord’s claim is established by the crop lien statute; while Bank’s notice of Landlord’s claim deprives Bank of the defense it could otherwise assert as a bona fide creditor (§ 66).

* * *

33. SP1 has a perfected, first-priority security interest in Debtor’s inventory; SP2 is perfected in the same collateral with second priority. By agreement with SP1, the proceeds of Debtor’s inventory are to be devoted exclusively to the purchase of additional inventory. Debtor sells inventory, deposits the proceeds in his checking account, and draws on these funds to pay his debt to SP2. SP2 is aware of SP1’s security interest, is aware of the source of the funds, and is aware that payment to SP2 constitutes a breach of the security agreement between Debtor and SP1. Because SP1’s interest in the proceeds is paramount to that of SP2 (UCC §§ 9-315(c), 9-322(b)(1)), SP1 would be entitled to recover the funds from SP2 by the rule of this Section. (SP2’s notice of SP1’s interest deprives SP2 of the status of bona fide creditor. See § 67.) SP1’s claim is barred by a statute (UCC § 9-332(b)) that permits the payee of funds in a deposit account to take such funds free of competing security interests.

Reporter’s Notes:

* * *

Illustration 19 is based on Planter’s Bank & Trust Co. v. Sklar, 555 So. 2d 1024 (1990) (applying pre-revision UCC Article 9). Revised UCC § 9-109(a)(2) brings “agricultural liens” within the Article 9 structure, with the result that the priority contest between Landlord and Bank would now be regulated by § 9-322(a) and (g).

§ 57. Subrogation as a remedy.

(1) If a recipient is unjustly enriched by a transaction in which property of the claimant is used to discharge an obligation of the recipient or a lien on the recipient’s property, the claimant may obtain restitution

(a) by succeeding to the rights of the obligee or lienor against the recipient or the recipient’s property, as though such discharge had not occurred, and

(b) by succeeding to the rights of the recipient in the transaction concerned.

* * *
Comment:

*b* Subrogation to security. If a transaction that gives A a claim in unjust enrichment is one in which A’s funds have been used to discharge B’s obligation to C, the usual reason for A to seek a remedy via subrogation (as opposed to restitution via money judgment against B) is that C’s claim against B benefited from some form of security. Subrogation gives A recourse to the same security for the purpose of avoiding the unjust enrichment not only of B but of B’s junior lienors as well. * * *

The more characteristic function of subrogation appears when the restitution claimant is in competition with other creditors of the recipient, whether secured or unsecured. Subrogation to a secured claim is primarily justified in such cases by the need to avoid the unjust enrichment of competing creditors at the claimant’s expense. Subrogation of the claimant is not prejudicial to the other creditors, because its purpose and effect is to confirm the several claims against the recipient’s property in their appropriate priorities. See Illustrations 8-11.

Illustration:

11. Company borrows $50,000 from Bank to buy a new truck, giving Bank a security interest which Bank duly perfects. Three years later, with the Bank loan in default, Company borrows $35,000 from Trust Co. on the security of the truck and uses the proceeds of the new loan to repay Bank. Bank’s security interest is discharged of record, but Trust Co. neglects to perfect its security interest. Six months later the Trust Co. loan is in default with a balance of $30,000; Company is insolvent; the court appoints Receiver to dispose of Company’s assets. After the truck is sold at auction for $20,000, Receiver and Trust Co. assert competing claims to the proceeds in the hands of Receiver. Trust Co.’s unperfected security interest is subordinate to the interest of Receiver as “lien creditor” (see U.C.C. §§ 9-317(a)(2), 9-102(52)), but Trust Co. may be subrogated to the prior lien of the Bank loan that its funds were used to discharge. Subrogation in such cases will not be permitted to prejudice subsequent lienors or creditors who rely on a misleading record title; the court determines, however, that none of Company’s creditors relied on the apparent state of title to the truck during the six months it was improperly recorded. Trust Co. may recover the $20,000 proceeds via subrogation to Bank’s first-priority lien.

§ 58. Following property into its product and against transferees.

(1) A claimant entitled to restitution from property may obtain restitution from any traceable product of that property, without regard to subsequent changes of form.

(2) A claimant entitled to restitution from property or its traceable product may assert the same rights against a transferee who is not a bona fide purchaser (§ 66).

(3) When property from which a claimant is entitled to restitution is exchanged for a more valuable product, the interest acquired by tracing may be limited
(a) to protect innocent recipients against liability for consequential gains (§ 50(4));

(b) to protect the interests of certain third parties (§ 61(1)); or

(c) where the extent of the relief sought is grossly disproportionate to any loss on which the claimant’s right to restitution is based.

Comment:

* * *

d. What is a “traceable product”? The relationship by which one asset is properly regarded as the traceable product of another is one that legal authorities tend to treat as self-defining, and the concept must generally be illustrated by means of examples. (The relationship between collateral and “proceeds” in the law of secured transactions is closely analogous, but the conception of “traceable product” is broader than the current statutory definition of “proceeds.” See UCC § 9-102(64).)
### UCC FINANCING STATEMENT AMENDMENT

**FOLLOW INSTRUCTIONS (front and back) CAREFULLY**

<table>
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**B. SEND ACKNOWLEDGMENT TO: (Name and Address)**

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1a. INITIAL FINANCING STATEMENT FILE # 1b. This FINANCING STATEMENT AMENDMENT is to be filed (or record) (or recorded) in the REAL ESTATE RECORDS.

| 01-001275 |

2. **TERMINATION:** Effectiveness of the Financing Statement identified above is terminated with respect to security interest(s) of the Secured Party authorizing this Termination.

3. **CONTINUATION:** Effectiveness of the Financing Statement identified above with respect to security interest(s) of the Secured Party authorizing this Continuation Statement is continued for the additional period provided by applicable law.

4. **ASSIGNMENT (full or partial):** Give name of assignee in item 7a or 7b and address of assignee in item 7c, and also give name of assignor in item 6.

5. **AMENDMENT (PARTY INFORMATION):** This Amendment affects Debtor or Secured Party of record. Check only one of these.

- [ ] CHANGE name and/or address: Please refer to the detailed instructions in regards to changing the name/address of a party. be deleted in item 6a or 6b. and also item 7c

- [x] ADD name: Give record name to ADD name. Complete item 7a or 7b. and also item 7c

6. **CURRENT RECORD INFORMATION:**

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7d. SEE INSTRUCTIONS

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8. **AMENDMENT (COLLATERAL CHANGE):** check only one box.

- [ ] deleted or [ ] added, or give entire 'restated collateral description, or describe collateral [ ] assigned.

9. **NAME of SECURED PARTY or RECORD AUTHORIZING THIS AMENDMENT** (name of assignor, if this is an Assignment). If this is an Amendment authorized by Debtor which adds collateral or adds the authorizing Debtor, or if this is a Termination authorized by a Debtor, check here and enter name of DEBTOR authorizing this amendment.

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10. **OPTIONAL FILER REFERENCE DATA**

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The filing of this Statement does not amend any UCC record. This Statement is for informational purposes only.

CORRECTION STATEMENT (Claim Concerning Inaccurate or Wrongfully Filed Record)
FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF PERSON FILING THIS STATEMENT (optional)
   Michael Ellis, Pillsbury Winthrop Shaw Pittman LLP
B. SEND ACKNOWLEDGMENT TO: (name and address)

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Secured Party has reviewed its records and has confirmed that the UCC Financing Statement Amendment filed with the California Secretary of State on August 3, 2007, and assigned Document No. 13638640002 was filed in error and as a result of a clerical error. The Initial Financing Statement filed with the California Secretary of State on January 3, 1991, and assigned Document No. 91001275, as subsequently amended and continued, remains in full force and effect.

Bank of America, N.A.

Bank of America, N.A.

International Association of Commercial Administrators (IACA)
HYPOTHETICAL SCENARIOS

1. Lender has a first lien on Whiteacre and a second lien on Blackacre to secure a $5.8 million loan to Development Co., the owner of both properties. The loan is also guaranteed by the principal owner of Development Company. After Development Co. defaults under the loan agreement, Lender commences a nonjudicial foreclosure of Blackacre. At the ensuing public auction, Lender credit bids the full amount of the $5.8 million debt, even though Blackacre was almost fully encumbered by the first lien. Lender was the high bidder. After realizing that its bid inadvertently extinguished the debt, which would preclude any effort to foreclose on Whiteacre or to enforce the guaranty, Lender brings and action in equity to have the foreclosure sale set aside. Is Lender entitled to such relief? May it still enforce the lien on Whiteacre or the guaranty? See Vestin Realty Mortgage I, Inc. v. Pickwick Partners, L.L.C., 2009 WL 507115 (Mo. Ct. App. 2009).

2. Wholesaler sells goods on open account to Customer. Wholesaler then sold that account, along with others, to Factor. Factor instructed Customer to make payment directly to it.
   A. After receiving Factor’s instruction, Customer received a contrary instruction from Wholesaler, which said that Factor’s instruction was in error and that Customer should pay Wholesaler. Customer chose to disregard Factor’s instruction and paid Wholesaler. Later, Factor successfully sued Customer on the account and Customer was forced to pay Factor (i.e. to pay twice). See § 9-406(a). Does Wholesaler have a restitution claim against Wholesaler? See Restatement (Third) of Restitution § 6, ill. 18.
   B. How, if at all, would the result change if Customer did not receive any contrary instruction from Wholesaler, but simply paid Wholesaler because Customer forgot about the instruction from Factor, and was later forced to also pay Factor? See Restatement (Third) of Restitution § 6, ill. 7.

3. Distributor sells goods on open account to Customer. Distributor used the account due from Customer as part of its collateral base securing a loan from Bank. Bank properly perfected its security interest. Later, Distributor gave a junior security interest in its accounts, including the one due from Customer, to Finance Company. Finance Company instructed Customer to pay it directly, which Customer did. If Distributor defaults on its loan from Bank (or was already in default at the time of Customer’s payment), does Bank have a claim in restitution against Finance Company? See UCC §§ 9-330, 9-607 cmt. 5.
4. Seller contracts to sell steal beams for $100,000 to Builder, who plans to use them in a construction project. Seller knows of Builder’s plan but the contract between disclaims Seller’s liability for consequential damages. Shortly before Seller is to deliver the steal beams to Builder, Seller sells them for $180,000 to Contractor, who is in desperate need of such beams for a different construction project. Seller therefore is unable to perform the contract with Builder and breaches. Builder is able to cover, with some effort and after experiencing some delay, for $130,000. How much may Builder recover from Seller under Article 2? See § 2-712. How much may Builder recover from seller in restitution? See Restatement (Third) of Restitution § 39.
Zero-based morality

The case of the $31-million typo

For nearly five years, Wall Street lawyers not directly involved watched in horrified fascination there but for the grace of God!—the litigation spawned by the "$92 million typo."

It was a memorable flub: The accidental omission of a comma and three zeros—a mere "0.000"—supposedly reduced the amount of a first mortgage held by the Prudential Insurance Co. from $92,885,000 to $92,885.

Today, the various suits have at last been decided or settled. Tallying up what it paid in settlement costs, legal fees and the costs of delay, Prudential claimed the mistake cost it $31 million. Newspaper stories say Prudential has recovered some of this loss from its lawyers and their malpractice insurers.

Across the country, the law firm associates, paralegals and support staff who have been told this story as an in terrorem lesson in the importance of proofreading must now number in the tens of thousands. There's no denying the importance of accuracy: As Bayless Manning once said to me, "In law school you learn about law; in a law firm you learn to be careful."

Seen in one light, the "$92 million typo" has actually been a boon for the profession—a dramatic demonstration that those expensive and seemingly redundant hours spent fussing over documents might actually be cost-effective for the clients who pay for them. But I think the real lessons of the "missing zeros" are very different, and that their implications are far less benign.

The facts are simple. On April 14, 1986, as lawyers assembled closing documents for a refinancing of some outstanding debt of United States Lines (USL), a secretary working on something called "Amendment No. 1 to the First Preferred Ship Mortgage" omitted three zeros from the number representing the balance of USL's outstanding indebtedness to Prudential.

The erroneous figure—"$92,885.00"—was subsequently copied in dozens of other documents. Although lawyers from five or six different law firms and in-house legal departments were presumably reviewing the documents as they prepared for the closing, nobody noticed the error. The papers were filed and forgotten—until November of that year, when USL defaulted on the notes secured by the amended mortgage.

The critical fact is this: Nobody with an interest in the matter was ever mistaken about the amount of Prudential's first mortgage. No creditor asserted that it had relied on erroneous information about the amount of USL's existing debt. The lender that tried most aggressively to profit from the situation—General Electric Capital Corp. (GECC), formerly GE Credit—had been intimately involved in USL's financing for some years and knew as much about the Prudential mortgage as Prudential itself.

The only mistake, in short, was the one made by the typist. As soon as the typo was discovered, both its nature and the true state of affairs were immediately apparent to every interested party.

Simple logic best

What should be the legal consequence of a typographical error under these circumstances? A fair-minded person who had not been to law school would answer "None"—or, at most, that the re-
in those circumstances Prudential would normally be entitled to restitututory relief, though subject to equitable defenses to protect the subsequent creditors' change of position.

But nothing of the sort happened. No one was mistaken, at any point, about the extent of USL's indebtedness to Prudential. The case of the "missing zeros" is remarkable, among other reasons, because in ordinary legal terms it involved no real mistake at all.

Properly viewed, this fabulous typo was legally insignificant. To give it legal effect would only enrich junior lienors (who had done nothing to deserve it) at the expense of Prudential (who had done nothing to deserve it either). It really is that simple. So what happened in real life?

Quick big bucks

When Prudential tried to foreclose its $92,885,000 first mortgage, USL's bankruptcy trustee objected that the mortgage should be limited to $92,885. The trustee eventually agreed to withdraw his opposition to the Prudential mortgage (and to help Prudential defend its mortgage against the attacks of the junior lienors) in exchange for 17.5 percent of the net proceeds to Prudential from the sale of the mortgaged vessels. Because the sale realized something over $65 million, this payment amounted to more than $11 million.

Next, GECC, which (along with Prudential) held USL notes secured by a second mortgage, brought suit in admiralty for a declaration that Prudential's first mortgage was valid only to the extent of $92,885. Both in the Southern District of New York and on appeal to the Second Circuit, GECC lost. Prudential then sued the various law firms involved in the refinancing, alleging—as noted—that the expenses of settlement, legal fees and delay resulting from the typographical error had cost it $31 million.

Prudential may have figured its losses liberally for ad damnum purposes, but if we add the legal expenses of GECC, and the cost to three law firms and their insurers of defending Prudential's malpractice claims, the aggregate expenditure was certainly very large.

Net result: an alleged $30 million or so in losses, as the result of a typographical error that in a properly functioning legal system would be disregarded as trivial. This is a catastrophic result for which we can scarcely blame a legal secretary. A typist's momentary lapse was only the occasion of these losses, not in any real sense their cause.

What it all means

Such an expensive object lesson should teach something more interesting than simply, "Don't let this happen to you." I think it does.

Lesson No. 1: It is easy for highly skilled lawyers to miss the forest for the trees.

A properly framed suit for equitable relief on behalf of Prudential should have had virtually a 100 percent prospect of success. Yet Prudential, after consulting with its lawyers, decided it was worth giving up 17.5 percent of the net proceeds of its collateral to persuade USL's bankruptcy trustee to withdraw his objections to the first mortgage.

In appraising the value of the trustee's claim, Prudential inevitably had to include the costs of litigation and the consequences of delay in selling the vessels. Even so, Prudential (on the advice of able counsel) appears to have seriously overestimated the significance of the missing zeros.

Prudential's lawyers will reply that I am misstating (by oversimplifying) the dilemma in which they found themselves. It is true that under the particular circumstances of the USL mortgage, Prudential had simultaneously to confront two of the more formidably specialized bodies of commercial law. The maritime setting of the transaction,

Kull, formerly a Wall Street securities lawyer, is an associate professor of law at Emory University in Atlanta.
combined with USL’s insolvency, meant that the consequences of the missing zeros might arguably be governed in some respects by both the Ship Mortgage Act and the Bankruptcy Code.

The Ship Mortgage Act sets forth technical recording requirements for the validity of a preferred mortgage like Prudential’s. The missing zeros made it possible to assert that the requirements had not been met.

Prudential’s second source of concern, the Bankruptcy Code, contains a notorious “strong-arm clause” permitting a trustee to set aside unrecorded liens and equitable interests. The outermost reach of the trustee’s strong-arm power is a question of considerable uncertainty: The language of the statute might arguably extend to Prudential’s mistakenly recorded mortgage.

In short, if you looked hard enough and closely enough at the Ship Mortgage Act and the Bankruptcy Code, you might convince yourself (especially if you were an expert in admiralty or bankruptcy) that Prudential had a serious problem.

To see the fallacy of this conclusion, look up from the U.S.C.A. and ask yourself this: In your experience of the American legal system, with all its shortcomings, do you find it conceivable that the adjudicated effect of a typographical error by which no one was misled could be to reduce the amount of a valid mortgage by $92 million?

While I think the answer is clear, I recognize that no one would pay for this sort of legal advice. That’s why Prudential got the kind of advice people will pay for: the incontrovertible opinion, based on a careful reading of the statute, that such-and-such a possibility cannot be ruled out.

Lesson No. 2: Most lawyers don’t know anything about restitution.

It is much easier to feel confident about the common-sense solution to the “missing zeros” problem if you can advise your client, not only that such an outcome is consistent with reason and justice, but that it is unmistakably required by an extensive body of law. It helps enormously, in other words, to recognize that the important legal issue raised by the missing zeros is the threat of unjust enrichment, and to remember that the law offers many ways to prevent that very thing.

None of the five published judicial opinions in the “missing zeros” litigation—two in the Bankruptcy Court, one in the Southern District, one in the Second Circuit, and one in New York’s Appellate Division—contains the word “restitution” or the expression “unjust enrichment.” None contains a citation to George Palmer’s four-volume treatise, The Law of Restitution (1978). (Because it is the only American treatise on the subject, and because it abounds in statements helpful to Prudential’s position, one would expect to see Palmer’s work cited somewhere in the five opinions if the restitution issues had been adequately briefed.)

Although I have not read the papers submitted by Prudential in the various proceedings, the silence of the opinions suggests to me that Prudential’s lawyers failed to recognize either the strongest ground on which to argue their client’s position or the best source of helpful authority.

One reason for this failure—beyond the occupational hazards referred to in Lesson No. 1—is surely the fact that law schools have given up teaching Restitution. Most lawyers, and many judges, fail to recognize restitution issues when they come across them. As a result, these issues tend to be addressed by circumlocution and second-best analogies if they are addressed at all. When lawyers and judges are no longer familiar with the basic rules of an important body of doctrine, the administration of justice suffers. Prudential’s misfortunes are but an exaggerated illustration of a common problem.

The law schools that gave up Restitution doubtless told themselves that the important elements of the subject were being covered elsewhere. They are not. Reformation, the obvious first choice of remedy for the missing-zeros problem, lies somewhere on the margin of the typical Contracts syllabus. Many students graduate without hearing it mentioned.

Today’s law students are even less likely to learn that there is an extensive body of law devoted to

Most lawyers fail to recognize restitution issues when they see them.

avoiding unjust enrichment, and that a person at whose expense another is unjustly enriched has ipso facto a powerful claim to legal and equitable relief. This is the premise that provides Prudential with its unanswerable arguments in the missing-zeros situation, but it is a premise that—judging from the judicial opinions—Prudential’s lawyers never entirely grasped.

Business lawyers in an era of statutes are accustomed to answer legal questions by interpreting codes and regulations. Lawyers who spend every day of their professional lives addressing the requirements of enacted law tend to lose what familiarity they once had with common law rules. Yet common law not only decides the question not covered by statute, it supplies the background against which any statute is interpreted—even the Ship Mortgage Act or the Bankruptcy Code.

The common law of restitution is as much a source of these interstitial and background rules as is
the common law of contracts, but this is particularly difficult to recognize if you have never heard of the subject.

Lesson No. 3: The duty of zealous representation does not justify a lawyer in pursuing the unjust enrichment of his or her client.

The disappearance of Restitution from the law school curriculum has tended to obscure the fact that our legal system sometimes imposes civil liability on the basis of what is overtly a judgment about ethical behavior. Restitution, in Lord Mansfield's definition, identifies the circumstances in which a person who has received a benefit "is obliged by the ties of natural justice and equity to refund the money." In such instance, the law will enforce society's moral sense with a judicial decree.

If the ordinarily conscientious lawyer has not learned that "unjust enrichment" is grounds for civil liability, he or she is less likely to perceive that conduct tending to produce unjust enrichment is something a client should avoid.

Can it be the duty of a trustee in bankruptcy to raise technical objections to the validity of a lien if the effect of successful opposition, and of any settlement extracted from the lienor, can only be the unjust enrichment of junior liensors, unsecured creditors or shareholders?

Can it be part of a lawyer's duty to a client to raise technical objections to the validity of a prior lien, if the effect of setting aside the prior lien can only be the unjust enrichment of his client at the expense of the prior lienor? Is it possible to distinguish this situation from that in which the lawyer is asked to assert a claim he knows to be made in bad faith?

If the missing zeros had been held to reduce the amount of Prudential's first mortgage from $92,885,000 to $92,885, the net effect (given the proceeds of the collateral and the parties' respective holdings of the second-mortgage notes) would reportedly have been to transfer approximately $24 million from Prudential to GECC, without even the pretense of an antecedent obligation. Is such a result, achieved by legal process, morally distinguishable from theft?

When the officers and directors of General Electric Capital Corp. asked their lawyers to try to obtain for GECC shareholders some $24 million belonging to shareholders of the Prudential Insurance Co., what on Earth did they think they were doing? What did GECC's lawyers think they were doing?

I think I can predict the gist of GECC's rejoinder: "We're just asserting rights that we're advised may be given us by the Ship Mortgage Act of 1920, and ours is not to reason why." Would such an answer still be comfortable if GECC's lawyers had advised their client that any advantage gained would be something the law condemns as unjust enrichment? The lawyers would add, of course, that the attempt to gain such an advantage was—for that very reason—almost certain to fail.

A moral underpinning

Reform of the law school curriculum will not correct the larger inefficiencies of the American legal system, and courses in professional responsibility will not deter opportunistic behavior.

Several factors assured that the missing zeros would prove an expensive error for Prudential and its lawyers. These included: 1. the sheer novelty of the "$92 million typo" (the fact, that is, that a trivial error carried such monumental implications); 2. the resulting uncertainty as to possible consequences, and 3. the size of the potential windfall coupled with the absence of any effective sanction to inhibit socially costly opportunism.

The cost to Prudential and others might have been substantially less if the lawyers and judges who handled the dispute had recognized that it posed, first and foremost, a problem in restitution. This meant that the law's primary concern in regulating the consequences of the missing zeros was to prevent unjust enrichment.

If we recall that our legal system ordinarily attempts to prevent unjust enrichment, it becomes much harder to accept any interpretation of the Ship Mortgage Act or the Bankruptcy Code by which one party would receive a pointless windfall at another's expense. In the absence of any reason to suppose that Congress intended such a consequence, the factor of unjust enrichment becomes decisive.

The law of restitution is not only a source of rights and remedies. Its moral underpinning, consisting of an ethical judgment about benefits that a party cannot in good conscience either seek or retain, contributes to what constitutes a good-faith claim by a litigant.

Because I assume that GECC's lawyers are conscientious, I assume that they would have advised their client differently had they been aware (as I assume they were not) that any benefit flowing to GECC from the mistaken description of Prudential's mortgage would be condemned by the law as unjust enrichment.

The moral question has its practical side as well. Lawyers more sensitive to restitution could have advised GECC more accurately about its chance of prevailing in any litigation in which GECC's position, seen for what it was, consisted of asking a court to decree its unjust enrichment at the expense of an innocent party. With better advice on this point, GECC might have made better use of the money invested in its speculative lawsuit against Prudential.

Identifying the demands of "natural justice and equity" is often precisely what is in dispute between litigants. Where the equities are as clear as they were in the case of the missing zeros, however, Lord Mansfield's criteria still offer clues about litigation strategy that can be expensive to ignore.
Restitution Issues in Bankruptcy Cases

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Constructive Trusts in Bankruptcy

Constructive trusts are used as an equitable remedy to return property to its rightful owner after there has been a “non-consensual transfer.” Andrew Kull, Restitution in Bankruptcy: Reclamation and Constructive Trust, 72 Am. Bankr. L. J. 265, 265-66 (Summer 1998) (hereafter “Kull”). The transfer could be “non-consensual” because the underlying agreement to transfer the property was void or voidable, as where the transfer was the result of fraud, mistake, or coercion. Id. at 277. Imposition of a constructive trust is a declaration that the holder of the property is not the true owner and mandates that the holder return it to the transferor as the rightful owner. Id. at 278, 290.

Problems in analyzing constructive trusts have arisen in the bankruptcy context. See, e.g., In re Omegas Group, Inc., 16 F.3d 1443 (6th Cir. 1994). One can understand why bankruptcy courts might pause to impose a constructive trust in bankruptcy given that the result would be to award one creditor a one hundred percent return on its property while another creditor gets only pennies on the dollar. Perhaps for this reason, the Omegas court declared that “[c]onstructive trusts are anathema to the equities of bankruptcy since they take from the estate, and thus directly from competing creditors, not from the offending debtor.” Id. at 1452. The Omegas court went on apparently to decide that constructive trusts do not have a place in bankruptcy law, and that defrauded creditors should instead seek to have their debts declared nondischargeable. Kull at 266, 272.

The problem with the Omegas court’s conclusion is that it mistakes the constructive trust claimant for just another creditor. A constructive trust claimant is not a creditor; she is the true equitable owner of the property. Kull at 284. The transferee/debtor therefore holds only legal title. Id. at 279. Where the transfer is void because of fraud, for example, this legal title must pass back to the transferor who is restored to ownership of the property. Id. Thus, while at first blush it may appear unfair that one “creditor” gets paid far more than another, the Omegas result is in fact the more unjust because the result is that the constructive trust claimant’s property is pulled into the estate, and used to pay the debtor’s creditors.

The Second Circuit similarly has restricted the availability of constructive trusts in bankruptcy litigation. See, e.g., In re First Central Financial Corporation, 377 F.3d 209 (2d Cir. 2004). In First Central, the court first noted that New York substantive law requires fraud in order to impose a constructive trust. 377 F.3d at 216-17. But the court saw nothing fraudulent in the trustee’s marshaling of assets of the estate, and thus there could be no basis on which to impose a constructive trust. Id. This initial premise is arguably incorrect because the “fraudulent” transaction was that between the constructive trust claimant and the debtor, thus the trustee could only take the title the debtor had, which was a voidable one because of the initial fraud. But the court went further. It followed Omegas in expressing concern that the constructive trust doctrine disrupts the Bankruptcy Code’s priority system. Id. at 217. First Central did recognize potential tension in its hesitancy to apply New York constructive trust law. Id. at 217-18. On the one hand, the court noted that property of others was not included in the bankrupt’s estate. Id. But the court still suggested it had to “act very cautiously’ to minimize conflict with the goals of the Bankruptcy Code.” Id. In the court’s view the “equities of bankruptcy are not the equities of the common law.” Id. (quoting Omegas, 16 F.3d at 1452). Thus, the Second Circuit made it more difficult to obtain a constructive trust first by
focusing on the debtor-trustee transfer rather than recognizing the trustee could only take the voidable title that the debtor held, and by imposing a nebulous additional consideration of the “equities of bankruptcy” that would apparently condone using another’s property to pay the debtor’s debts.

The Supreme Court’s decision in *Travelers Casualty and Surety Company of America v. Pacific Gas and Electric Company*, 549 U.S. 443 (2007) seemed to signal the end of disparate treatment of constructive trusts in bankruptcy as in *Omegas and First Central*. In *Travelers*, the Supreme Court took on the Ninth Circuit’s “Fobian rule,” which categorically denied attorneys’ fees to claimants litigating in bankruptcy court even where state law or the parties’ own contract would allow for a fee award. A unanimous Supreme Court rejected the *Fobian* rule. The Court first noted that the debtor’s obligations even in bankruptcy are based on underlying substantive state law, except where there are contrary provisions of the Bankruptcy Code. *Travelers*, 549 U.S. at 20. The Court reiterated that “[p]roperty interests are created and defined by state law, and unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.” *Id.* at 450-51 (internal quotations omitted). Given that there was no section of the Bankruptcy Code that “clearly and expressly” compelled courts to follow the *Fobian* rule, the Court decided it must be discarded and that courts should follow substantive law in making fee awards. *Id.* at 453-54.

One would think that *Travelers* would preclude courts from relying on the notion that the equities of bankruptcy being different than those of the common law because *Travelers* clarifies that state law remedies are not to be treated any differently merely because they are being asserted in the bankruptcy context. Following *Travelers*’ guidance, a court would have to be able to point to “clear and express” statutory language that compelled a different result than that provided by state substantive law. *Travelers*, 549 U.S. at 453-44.

Yet, the Second Circuit in a recent post- *Travelers* decision seems to have bucked the Supreme Court’s dictate. *In re Ades and Berg Group Investors*, 550 F.3d 240 (2d Cir. 2008). The *Ades and Berg* court perpetuated the First Central error by examining the debtor-trustee transfer for fraud, and finding none because the trustee merely marshaled assets as was his duty per the Code. *Id.* at 245. The Second Circuit viewed its decision in *Ades and Berg* as consistent with *Travelers* because it made its decision based on New York state substantive law on constructive trusts. *Id.* But the Second Circuit missed that it had continued to consider “the special equities of bankruptcy” without clear and express statutory language compelling a different result that would be attained under New York law contrary to *Travelers*’ command. In short, despite *Travelers* seemingly clear dictate that state law be applied no differently to claims merely because they are asserted in bankruptcy court, *Ades and Berg* continues the error of treating constructive trust claims differently - while claiming that it was not doing so.

More to the root of the problem, *Ades and Berg* continues to miss the fundamental difference between constructive trust claimants and other creditors – constructive trust claimants are owners of the property involved and that property is therefore not truly part of the estate. Perhaps the upcoming Restatement (Third) of Restitution will re-ground decisions in this area. Section 60 of the
upcoming Restatement critiques the Omegas and First Central rationale and suggests that the proper resolution of a case involving a meritorious constructive trust claimant is to find that the claimant is the owner of the property, and that it is not part of the estate, just as a state court would find applying its own substantive law. Restatement (Third) of Restitution § 60 cmt. f.

A variation on constructive trust law to bring property into the bankruptcy estate instead of excepting it out of the estate was discussed this year in In re McLain, 516 F.3d 301 (5th Cir. 2008). The court determined there was an issue of fact on whether the debtor used property of the estate (in the form of cash the debtor wrongfully hid from the trustee and court) to pay an initial premium on a life insurance policy. Applying state law and Restatement of Restitution § 210 (1937), the court held that use of funds wrongfully taken from the bankruptcy estate to make premium payments on the policy creates a property interest in the policy proceeds on behalf of the owner of funds wrongfully obtained, the bankruptcy estate. 516 F.3d at 314. Whether the estate was entitled to a pro rata share of the proceeds or simply reimbursement of funds wrongfully obtained was held to depend on the culpability of the person who wrongfully used the funds. 516 F.3d at 314, 316. See Restatement (Third) of Restitution Section 58, above, on tracing a restitution claim into its product and proceeds.

Claims by Ponzi-Scheme Victims in Bankruptcy

Where a Ponzi victim can identify a transfer done with an actual intent to defraud creditors, the entire transferred payment must be returned. Scholes v. Lehmann, 56 F.3d 750, 757 (7th Cir. 1995) (analyzing transfers under Illinois fraudulent conveyance statutes). Where there is only constructive fraud, the transferor will only have to return the portion of the payment that exceeded the consideration the transferor gave for it. Id. Recovering the profits secured by an innocent investor in a Ponzi scheme is based on the rationale that it is not a true profit, but is instead a fraudulent conveyance of another’s money. Id. at 757-58.

Similarly, under 11 U.S.C. § 548(a) a court can order disgorgement of profits earned in a Ponzi scheme even absent a showing of actual fraud. Under § 548(a), the bankruptcy trustee may avoid a transfer that is not for equivalent value if it is made within two years of the petition date. An exchange is only for equivalent value if it is just that – equal; meaning a dollar for dollar exchange. See, e.g., In re United Energy Corp., 944 F.2d 585, 595-97 (9th Cir. 1991). But profits are not equivalent because by definition profits are a return in excess of the amount contributed. Therefore, the trustee may recover profits “earned” by Ponzi investors for the benefit of the bankruptcy estate. Id.; In re Slatkin, 525 F.3d 805, 815 (9th Cir. 2008) (all payments to investors made by operator of Ponzi scheme and representing profit on their investments are avoidable fraudulent transfers. Transfers not insulated from avoidance under § 546(e) because the debtor was not a stockbroker; although he had customers, he was not in the business of effecting securities transactions). And, as
in *Scholes*, if there is an actual intent to defraud the entire payment may be avoided, provided that it was within two years of the petition date. 11 U.S.C. § 548(a)(1)(A).

A recent trend cuts off liability even where the original Ponzi victim’s funds can be traced into the hands of a later creditor who got a return on her investment without notice of the fraudulent scheme – *i.e.*, a “bona fide creditor.” *See, e.g., In re AFI Holding, Inc.*, 525 F.3d 700, 707 (9th Cir. 2008) (transfer may only be avoided under § 548 if there was a lack of good faith). Under the “good faith” defense, the transferee is considered to have given reasonably equivalent value by implicitly relinquishing its claim for restitution. *Id.* at 708. Thus, an investor was protected to the extent that payment returned his initial investment but was not protected to the extent the payment represented fictitious profits from the scheme. *Id.; but see Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008) (declining to allow Ponzi victim a credit against the perpetrator for money paid in taxes in good faith belief in having made a profit).

Assuming the remaining Ponzi victims cannot trace their funds and are thus similarly situated, they would be left to receive a pro rata distribution of the estate’s assets. Kull at 285.

A variation on a Ponzi scheme occurred in the recent USA Commercial Mortgage bankruptcy case. The debtor, a mortgage loan broker and servicing company, arranged for people seeking investments to participate in secured loans to developers. Some developers defaulted on interest payments. The debtor took principal payments by other developers and used the money plus other funds on hand as “interest” payments to all the investor/lenders, rather than informing anyone of defaults. In effect, the debtor “prepaid” some innocent investors with funds intended for others, leaving them as victims of diverted principal payments they could not recover from the bankrupt servicing company.

In these circumstances, the bankruptcy debtor sought to recover the “prepaid” interest from the recipient investors for distribution to all unsecured creditors, including the investors whose principal was diverted. The diverted principal victims claimed entitlement to all of the money, arguing it was paid based on a mistake of fact or law; the debtor argued that funds were commingled and could not be traced, and the prepaid interest recipients argued that they were innocent and entitled to be paid interest on their loans. The parties settled. *See, e.g. Wilson v. Newman*, 463 Mich. 435, 617 N.W. 2d 318 (Mich. 2000) (payments made under mistake of fact may be recovered from a third party creditor where the creditor has not changed its position in reliance on the payment); *Mfrs. Hanover Trust Co. v. Chem. Bank*, 160 A.D.2d 113, 559 N.Y.S.2d 704 (N.Y. App. Div. 1990); *St. Paul Fed. Sav. & Loan Ass’n v. Avant*, 481 N.E.2d 1050, 1057 (Ill. App. 1985) (granting the plaintiff restitution where both plaintiff and defendant were defrauded by a third party, holding that although defendant took the payment in good faith and without notice of the fraud, it failed to show detrimental reliance); *Grand Lodge, A.O.U.W. of Minn. v. Towne*, 161 N.W. 403, 405 (Minn. 1917) (holding, in successive-fraud case, that defendant/payee “has no right to the money as against plaintiff, and his

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1 Note that if the Ponzi investments could be traced by any investor, that investor might be able to impose a constructive trust on the money. *First Federal of Michigan v. Barrow*, 878 F.2d 912, 915 (6th Cir. 1989).
retention of it is against conscience unless by the payment defendant’s position has been irrevocably changed to his loss”).

**Innocent Creditor Versus Innocent Creditor**

Can a jilted creditor avoid dealing with the bankrupt debtor by pursuing another of the bankrupt’s creditors? Imagine a situation where A owns an asset and leases that asset to B. The asset needs maintenance to remain operational, so B contracts with C to provide maintenance. Later, assume B becomes insolvent. But by this time C has done work that has benefited A because it kept A’s asset operational. Should A have to pay C even though there was no contract between A and C just because A got an incidental benefit from the B-C contract? The answer is: it depends. C will have to show conduct on A’s part sufficient to create a restitution claim.

Unjust enrichment does not result merely because C has done work on A’s asset based on a contract with B and B’s promise to pay. Otherwise, A would be converted into an unwitting surety for B. There needs to be something more to make A’s benefit unjust.

This “something more” was present in *Midcoast Aviation v. GECC*, 907 F.2d 732 (7th Cir. 1990). GECC presented the A-B, B-C scenario described above. GECC owned an airplane that it leased to AAI. AAI wanted to refurbish and market the plane, and it contracted with Midcoast to do the repairs. AAI later became insolvent, and Midcoast looked to GECC for payment. A jury found for Midcoast and GECC appealed. The appellate court affirmed. It noted that there was sufficient evidence for the jury to conclude that GECC “enticed” Midcoast to do the work and GECC created an expectation of payment in Midcoast. *Id.* at 739-40. Thus, in that situation it would be unjust for GECC to retain the benefit of the work without paying – because there was something more than an unsatisfied contractual expectation in the “B-C” contract.

Similarly in *Knox v. Phoenix Leasing, Inc.*, 29 Cal. App. 4th 1357, 1359 (1994) the California Court of Appeals found that as between innocent creditors, there can be no recovery unless there are “unusual circumstances” to justify the award. Knox recognized that recovery is the exception to the general rule, but that whether unusual circumstances are present might be a question of degree. It held fraud would be enough, or the initiation or encouragement of the transaction that could be reached by the doctrines of estoppel, misrepresentation or mistake. 29 Cal. App. 4th at 1365; 35 Cal. Rptr. 2d at 147-48. “If [the creditor] had an active hand in promoting a transaction that goes bad, a secured creditor should not escape with a victimized supplier left behind holding an empty bag alone. In simple terms, the creditor should not be allowed to profit from the wrong of its own bad faith.” *Id.*

The *Knox* court noted that a more difficult case arises when the secured creditor has acquiesced in an unsecured creditor providing goods or services to their common debtor. If the goods or services are necessary to preserve the collateral, especially if perishable, the secured creditor would ordinarily incur that cost on its own as part of its reasonable care as the custodian of the collateral. 29 Cal. App. 4th at 1366 citing *Ninth Dist. Prod. Credit v. Ed Duggan*, 821 P.2d 788 (Colo. 1991),
and *Producers Cotton Oil Co. v. Amstar Corp.*, 197 Cal. App. 3d 638 (1988). But the Knox court went on to explain that acquiescence cannot carry the risk of restitution liability without turning the principles of UCC Article 9’s notice-filing system on its head. It would destroy creditors’ reliance on that system and substitute a new duty to warn and disclaim, rewarding ignorance and establishing an incentive for unsecured creditors to ignore the notice filing system. *Knox*, 29 Cal.App.4th at 1367.

In sum, for a court to hold a secured party liable for unjust enrichment by an unsecured creditor supplier, there would need to be “something more” than just the conferring of a benefit by another creditor. The something more would have to be exceptional, lest courts unwittingly undo the certainty provided by UCC Article 9. *Cf. Knox*, 29 Cal.App.4th at 1367-68.

**Discharge for Value Defense**

The defense of discharge for value to a restitution claim may arise in commercial bankruptcy cases. *See In re Calumet Farm, Inc.*, 398 F.3d 555 (6th Cir. 2005). Calumet initiated a wire transfer of $77,301 by payment order to its bank. The bank mistakenly wired $770,301 to White Berch’s bank, and the recipient bank and White Berch refused to return the money; Calumet declared bankruptcy. The transferor bank sued the transferee, White Berch, under UCC § 4A-303(a), which authorizes a bank to seek restitution from the beneficiary of an excess payment if the bank committed an error in executing the payment order. The court held that this UCC provision and UCC § 4A-406(a) incorporate a discharge-for-value defense, citing the 1937 Restatement of Restitution. It provides that the transferee of funds in these circumstances is the equivalent of a bona fide purchaser and may keep the mistaken payment if the transferee made no misrepresentation and did not have notice of the transferor’s mistake. Restatement of Restitution § 14(1) (1937). The Restatement did not specify the point in time by which notice of the mistake must be received.

Noting that the transferee may have constructive notice of a mistake as a result of the size of the transfer, and that the entity to receive notice should be the one to whom funds were wired (the bank), the court ruled that the discharge for value defense arises unless the beneficiary (White Berch) receives notice of a mistake before it credits its debtor’s (Calumet’s) account. White Berch did not credit the funds it received on its books and records to the debt owed by Calumet until after it knew of the mistake, and therefore was not allowed to avail itself of the defense, entitling Calumet’s bank to restitution from White Berch. In that particular case, the transferor bank had settled a suit against it by its customer, Calumet, for $550,000 so its actual loss was $550,000 instead of the full $693,000 overpayment. The transferee, White Berch, received a windfall for the difference.

As noted above, Restatement (Third) of Restitution Section 6 provides for a restitution claim on account of a mistaken payment, and Section 17 addresses lack of authority. Other sections of Restatement (Third) of Restitution will address this and other defenses to restitution claims.
The Committee on Uniform Commercial Code focuses on commercial transactions and practices covered directly by the UCC as well as those covered tangentially. In doing so, the committee monitors commercial law developments affecting such transactions, pays close attention to how other law interacts with the UCC, generates commentary and model agreements in those areas, and actively participates in statutory reform efforts.

We welcome your interest and invite you to join the committee.

### Knowledge

The **Commercial Law e-Newsletter**, distributed via the members-only listserv, is filled with articles and updates on committee projects and programs, resources informing you on the latest trends and developments in UCC, and includes a unique column “Spotlight” intended to highlight recent UCC cases.

Have access right at your fingertips to **materials and resources** used throughout the year at the Section Spring Meeting and ABA Annual Meeting. Members can search the Section online **Program Library** for program materials dating back to 1999.

### Involvement and Networking

The committee meets twice a year at the Section Spring Meeting and ABA Annual Meeting. Meetings are another way to get involved in the committee's initiatives and also be informed of the latest developments in UCC-related topics through programs and forums by practitioners who have particular expertise in respect to the subject matter.

Members are welcome to join any of the various **subcommittees and task forces** within the committee, and the amount of time dedicated is entirely up to you. You have the opportunity to immerse yourself in various committee projects or simply be updated on committee activities and initiatives.

### Savings

- **Discounts on Committee and Section Publications and Products**, visit [www.ababooks.org](http://www.ababooks.org)
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