The Constructive Trust: A Remedy for Collecting After Embezzlement

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Employee embezzlement is one of the most common and costly problems facing private and public business organizations alike. The U.S. Chamber of Commerce estimates that the amount stolen annually from U.S. businesses by employees is somewhere between $20 and $40 billion. A 2012 report from the Association of Certified Fraud Examiners ("ACFE") reveals that nearly half of the victimized organizations do not recover *any* of the losses they suffer due to fraud. By the time the victim learns of the embezzlement, the misappropriated funds are rarely still in the hands of the wrongdoer, who often has no other assets from which a money judgment could be satisfied. Although the initial prospects of recovery may appear to be bleak, victims and counsel should not be easily discouraged, as there are potential remedies which can be quite useful in this context.

One particularly helpful but frequently overlooked remedy in embezzlement cases is the constructive trust. Even when the wrongdoer has no other assets and the misappropriated funds have been spent, recovery still may be had through the imposition of a constructive trust. A constructive trust is not actually a true trust, but a remedy available to a plaintiff seeking to recover specific property from another. Importantly, it extends not just to the property that was taken, but any property that was acquired in exchange for the stolen property, as well as any profit or enhancement in the value thereon. <u>Haskel Engineering & Supply Co. v. Hartford Acc. & Indem. Co.</u>, 78 Cal. App. 3d 371 (1978). In the proper situation, the court will compel the person in possession of that property to transfer it to the plaintiff.

Constructive trusts are authorized by case law and statute. California Civil Code section 2224 provides that a person who gains a thing by fraud, violation of a trust or other wrongful conduct is an involuntary trustee of it for the benefit of the person who would otherwise have had it. Civ. Code § 2224. Civil Code section 2223 provides that one who wrongfully *detains* a thing is an involuntary trustee of it for the benefit of the owner. Civ. Code § 2224. No conditions other than those stated in these code sections are necessary. <u>Lauricella v. Lauricella</u>, 161 Cal. 61 (1911); <u>West v. Stainback</u>, 108 Cal. App. 2d 806 (1952); <u>Estrada v. Garcia</u>, 132 Cal. App. 2d 545 (1955). All that is necessary to impose a constructive trust is a showing that the retention of the property by another would constitute unjust enrichment. <u>Calistoga Civic Club v. City of Calistoga</u>, 143 Cal. App. 3d 111 (1983). Thus it can be utilized when misappropriated funds have been used to acquire other property which is now in the hands of some third party.

In order to impose a constructive trust, however, the plaintiff must be able to trace the acquisition of that property back to the misappropriated funds—a concept known as "tracing."

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While "tracing" can prove to be difficult in certain situations, there are a number of interesting cases which show how the concept can be successfully applied to certain types of assets. These cases not only demonstrate how it is possible to recover from a third party in possession of certain property, but they also suggest that "tracing" might not be all that difficult in the case of an employer who has been the victim of employee embezzlement. Thus, plaintiffs should not be quick to dismiss the constructive trust due to perceived difficulties with tracing.

One particularly interesting line of cases shows how the constructive trust remedy is applied to insurance proceeds. Well-established authority in both California and the Ninth Circuit uphold the imposition of a constructive trust on life insurance proceeds where embezzled funds were implicated. For example, in Brodie v. Barnes, 56 Cal. App. 2d 315 (1942), the Court upheld imposition of a constructive trust on life insurance proceeds where a deceased employee had embezzled funds from his employer and paid the insurance premiums with those funds. The wife was the named beneficiary of the policy, and although she was not guilty of any wrongdoing, the Court imposed a constructive trust on the insurance proceeds in favor of the employer. The Court held that when a person embezzles funds and uses them to pay premiums for life insurance, a "trust" is created in favor of the person from whom they were embezzled, and such person is entitled to **such proportion of the total insurance as the amount of premiums which had been paid from the embezzled funds bore to the total amount of premiums paid.** Id. at 323. If any portion of the premiums on an insurance policy can be traced to embezzled funds, the plaintiff should be able to successfully impose a constructive trust on a portion of the proceeds.

Significantly, in employee embezzlement cases, it is not even necessary to trace the premium payments to the embezzled funds. For example, the Ninth Circuit Court of Appeal has held that a constructive trust is proper even where a dishonest employee's salary, rather than embezzled funds, is used to pay premiums. In Brown v. New York Life Ins. Co., 152 F.2d 246 (9th Cir. 1945), a deceased employee had embezzled money from his employer and used some of the funds to purchase life insurance policies on which his mother was the beneficiary. The trial court awarded the employer's representative the major portion of the proceeds from the life insurance policies. On appeal, the mother argued that the premiums were paid in large part by her son's monthly salary. The Court of Appeal dismissed the argument, stating:

> "[A]t the very moment any month's salary was about to be paid, he (the employee), as an officer or trust employee of the bank, should have advised the bank of his embezzlements. Failing in such duty, the salary monies paid him were infected by a trust of the whole thereof to the paying bank. The transaction might otherwise be described as the receipt by Edward N. Brown (the employee) of monies not due him, obtained under false pretenses of his performance of his trust obligations to his employer." *Id*. at 250.

Under the reasoning of this case, an employer should be able to impose a constructive trust on any property that was acquired with the employee's salary, not just property that was acquired with misappropriated funds that can be specifically traced. Other cases suggest that the imposition of a constructive trust is proper to protect the victim even if the premiums had been paid with legitimate, non-salary and non-embezzled funds, if such funds were placed in an account that ever contained such salary or embezzled funds. For example, in Mitchell v. Dunn, 211 Cal. 129 (1930), the California Supreme Court upheld the imposition of a constructive trust on real property in the possession of the defendant where the defendant commingled trust funds with personal funds in an account, purchased a residence drawing on that account, and depleted the account through withdrawals for personal expenses. The Supreme Court stated:

> "The specific piece of property involved was purchased with money taken from a fund containing trust moneys. All other moneys were dissipated. The law will not permit the trustee [thief] to say that the only permanent investment made with moneys from the fund was with personal funds, and that the dissipated funds belonged to the cestui [beneficiary or victim]. Under such circumstances it must be held that the property was purchased with trust [misappropriated] funds, and that defendant holds the title in trust for plaintiff." *Id*. at 134-136.

In Church v. Bailey, 90 C.A.2d 501 (1949), a deceased employee embezzled funds from his employer and placed it in a bank account with other personal funds. He withdrew nearly all of the embezzled funds, and later deposited substantial personal funds. Thereafter he bought property making payments from the account. After the employee's death, the employer brought suit against the employee's wife and the estate seeking a constructive trust on the property. The Court held that the entire account and the property purchased from the account was a constructive trust for benefit of the employer. The court stated that where an embezzler withdraws and spends the embezzled funds, and "subsequently makes additional deposits of his individual funds in the account, the money which the [embezzler] has deposited becomes a trust fund and the [employer] is entitled to hold the funds so deposited, and it is unnecessary to show an express intent upon the part of the [embezzler] to replace the trust funds." Id. at 504.

Even when the wrongdoer has other assets available to satisfy a money judgment, plaintiffs should still consider pursuing a constructive trust. Although it is recognized as an equitable remedy, California follows the majority view that an action to establish a constructive trust does not depend on the absence of an adequate legal remedy, and many cases have recognized a plaintiff's right to a constructive trust regardless of the defendant's solvency. Indeed, the imposition of a constructive trust may be more beneficial than a money judgment if those funds can be traced to the acquisition of property which has appreciated significantly in value. As one leading treatise explains, by the time the plaintiff obtains a final judgment, the original fund may have grown far greater than the legal rate of interest would recognize—to allow the defendant to pocket the difference would reward wrongdoing. Thus, a plaintiff who successfully pursues a constructive trust is entitled to any profits on and/or enhancement in the value of the wrongfully acquired property.

Whatever the facts of the case may be, victims of fraud and embezzlement must always consider the possibility of a constructive trust. While the cases mentioned in this article deal primarily with respect to insurance proceeds, it is important to remember that a constructive trust can be applied to virtually any type of property in a number of widely differing situations.