

**UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF VIRGINIA
Roanoke Division**

IN RE:

GENERAL CREATIONS, LLC,

Case No. 03-03058-7

Debtor

**MARRA DESIGN ASSOCIATES, INC.
LUND AND COMPANY INVENTIONS, LLC,**

Plaintiffs

v.

**Adversary Proceeding
No. 06-07095**

**WILLIAM E. CALLAHAN, JR., TRUSTEE for
GENERAL CREATIONS, LLC,**

Defendant

DECISION AND ORDER

At Roanoke in said District this 3rd day of January, 2008:

The matter before the court for decision involves a claim by Marra Design Associates, Inc. (herein Marra) and Lund and Company Inventions, LLC (herein Lund) for a constructive trust in a portion of settlement proceeds held by William E. Callahan, Jr., Trustee (herein Trustee) from Toys R Us, Inc.(herein Toys). The parties have filed with the court a stipulation of facts necessary for the court's determination as to whether a constructive trust exists in favor of Marra and Lund. In addition, the Trustee, Marra, and Lund submitted memoranda of authority and argument which set forth, in detail, their respective positions on the constructive trust issue. The court has considered the stipulation of facts, the written memoranda

and heard the parties in oral argument. For the reasons stated herein, the court holds that a constructive trust arose in favor of both Marra and Lund after the license agreements between them and General Creations, LLC (herein the Debtor) were terminated and the Debtor continued to manufacture and sell the property (herein collectively the Items) of Marra and Lund.

Facts:

A. The Marra Claim For Constructive Trust.

Marra and the Debtor executed an exclusive license agreement dated February 13, 2000, under which Marra licensed the Debtor with the exclusive right to manufacture, market, and sell Marra's Cotton Candy Makers (herein Makers). (Joint Stipulation ¶ 25). The license agreement contained a termination provision for "material breach which is not remedied within 30 days of written notice of such breach." (Joint Stipulation Ex. 16, p. 6). It also contained the following language:

In the event this Agreement is terminated, all rights of Licensor to Item including all patent, copyright and trademark rights shall revert to Licensor.

(Joint Stipulation Ex. 16, p. 6).

In late 2001 and early 2002, Debtor defaulted in the payment of royalties to Marra and failed to cure the default. (Joint Stipulation ¶ 26). By letter dated May 8, 2002, Marra provided the Debtor with formal notice of the termination of the license agreement, effective June 7, 2002, for failure to pay royalties due in the amount of \$290,645.29. (Joint Stipulation ¶ 27). After the effective date of the termination of the license, Debtor continued to manufacture

and sell the Makers without Marra's knowledge or consent.¹ (Joint Stipulation ¶ 28).

B. The Lund Constructive Trust Claim.

On August 15, 2002, Lund and the Debtor entered into a toy licensing agreement in which Lund granted to Debtor the exclusive right to manufacture and sell a doll called Hop-Along-Katie (herein the Dolls). (Joint Stipulation ¶ 16). The licensing agreement provided for an advanced minimum royalty payment of \$30,000.00 evidenced by a note payable to Lund by the Debtor. Pursuant to the terms of the agreement, failure by the Debtor to pay the note when due rendered the license agreement between Lund and Debtor null and void. Debtor failed to pay Lund the note when due thereby rendering the licensing agreement null and void. (Joint Stipulation ¶¶ 17, 20). Nevertheless, the Debtor continued to manufacture and sell the Dolls. Lund filed a bill of complaint in the Circuit Court of the City of Bristol, Virginia, and obtained temporary restraining orders dated February 13, 2003 and March 26, 2003, against the Debtor. (Joint Stipulation ¶ 22). By letter agreement between the Debtor and Lund, Lund agreed that Dolls under the control of the Debtor could be sold and shipped to Toys. The letter agreement provided for distribution of the sales proceeds between Lund and BB&T (the Secured Creditor). (Joint Stipulation ¶ 23).

C. Facts Relevant to Both the Marra and the Lund Constructive Trust Claim.

¹ Also, invoices bearing dates for the end of April 2003 and the beginning of May 2003 evidenced manufacture, sales and shipments of the Makers to Toys R Us, Inc. (Joint Stipulation Ex. 18).

In May 2003, within ninety (90) days of the commencement of the involuntary petition against the Debtor, Debtor sold and delivered to Toys the Lund Dolls and the Marra Makers together with a doll unrelated to the above-captioned adversary proceeding (the Lemonade Lisa doll). (Joint Stipulation ¶¶ 24, 30). The Debtor's invoices to Toys showed that it shipped: (a) 36,008 Dolls at a gross price of \$5.00 per doll for a total of \$180,040.00; (b) 23,588 Makers at a gross price of \$17.50 per toy for a total amount of \$417,790.00; and (c) 33,084 Lemonade Lisa dolls at a gross sales price of \$5.00 per doll for a total of \$165,420.00. The total amount invoiced to Toys was \$758,520.00. (Joint Stipulation Ex. 5, 19).

At the time of the Debtor's sales, Toys asserted that the Debtor owed it an amount for return of defective products previously sold. As a result, the Debtor gave Toys a 45% discount on its invoice as a defective product allowance thereby reducing the amount Toys owed to the Debtor to \$417,037.50. (Joint Stipulation ¶ 3). Toys did not pay the balance due the Debtor prior to the filing of the involuntary petition against the Debtor.

The Trustee initiated an adversary proceeding against Toys to recover the amount due for the estate. The Trustee settled the adversary proceeding in consideration of a payment by Toys to the estate of \$250,000.00 (herein the Settlement). (Joint Stipulation ¶ 1). Marra asserts that a constructive trust is imposed on the settlement proceeds in its favor entitling it to receive 54.44% of the settlement proceeds. Lund asserts a constructive trust in 23.74% of the settlement proceeds.

Both the Lund and the Marra license agreements make it clear that the Items

licensed (Makers and Dolls) are at all times considered to be property of the licensor.²

Discussion:

A. Elements Required for the Imposition of a Constructive Trust.

Marra and Lund assert that each held equitable title to their respective Items manufactured and sold by the Debtor to Toys after termination of the license agreements. They state that the Debtor owned only legal title to the Items and that their percentage interest in the invoice to Toys traces to the proceeds of the Settlement. All of the parties agree that the constructive trust law of Virginia is the applicable law for determination of the existence of a constructive trust. In re Dameron, 206 B.R. 394 (Bankr. E.D. Va. 1997), sets forth the Virginia law with respect to constructive trusts. The Dameron court explains that “[c]onstructive trusts ‘occur not only where property has been acquired by a fraud or improper means, but also where it has been fairly and properly acquired, but it is contrary to principles of equity that it should be retained, at least for the acquirer’s own benefit.’” Id. at 401 (quoting Leonard v. Counts, 221 Va. 582, 589, 272 S.E.2d 190, 195 (1980) (citation omitted)).

Marra’s and Lund’s respective license agreements are clear that the Items were never property of the Debtor. The granting of a license to the Debtor vested the Debtor with the requisite legal authority to manufacture and sell the Items. The license agreements provided for

² Paragraph 8, of the Lund agreement states: “It is understood a-reed [sic] that Licensor shall retain all right, title, and interest in the original Property and to any modifications or improvements made to the Property by Licensee.” (Joint Stipulation Ex. 11). Likewise in the Marra agreement, paragraph 2 states in part, “Licensee acknowledges the novelty of the Item and agrees not at any time or in any way, directly or indirectly to dispute the Item’s novelty or Licensor’s ownership.” (Joint Stipulation Ex. 16).

termination upon default by the Debtor. Default occurred, termination ensued, and the Debtor lost any right it had under the license agreement to manufacture and sell the Items. Upon termination, any title that may have passed to the Debtor under the license agreement reverted to Lund and Marra. Thus, at the time of the manufacture and sale of the Items to Toys, the Debtor wrongfully appropriated that which it formerly had under the license agreements and Marra and Lund became entitled to restitution. See Capital Investors Co. v. Morrison, 800 F.2d 424, 427 n.5 (4th Cir. 1986), indicating the Fourth Circuit's view that a constructive trust arises when the duty to make restitution arises.

In order to impose a constructive trust and recover, a claimant must trace its property into the other property which is made the subject of the trust. See Crestar Bank v. Williams, 250 Va. 198, 204, 462 S.E.2d 333, 335 (1995). In this case it is clear that the Items previously licensed to the Debtor were wrongfully manufactured and sold to Toys, that the invoice to Toys and the subsequent credit on the invoice reflect the amount due from Toys, and that the settlement with the Trustee is attributable to Debtor's claim for payment by Toys pursuant to the adjusted invoice for the Makers and Doll. See Haley, Chrisholm & Morris, Inc. v. Parrish, 127 B.R. 366, 371 (W.D. Va. 1991). Thus, the stipulations demonstrate that the settlement proceeds can be traced back to the Items.³ In addition, the percentage of settlement

³ The settlement proceeds were derived from the claim for payment against Toys which the Debtor held as of the date of the involuntary petition. The Trustee pursued collection and settled for an amount (\$250,000.00) less than the original claim (\$417,037.50). The original claim is directly linked to the original invoice amount of \$758,520.00. The original invoice amount was generated through the improper use by the Debtor of terminated license rights to manufacture and sell the Items.

proceeds that both Marra and Lund seek is accurate.⁴

B. The Amount of the Constructive Trust.

The purpose for the imposition of a constructive trust is to prevent fraud or injustice that would otherwise ensue. In re Dameron, 206 B.R. at 401. The “constructive trust is merely a procedural device by which a court of equity may rectify certain wrongs.” X-it Prods., LLC v. Walter Kidde Portable Equip., Inc., 155 F. Supp. 2d 577, 658 (E.D. Va. 2001) (citing New Amsterdam Casualty Co. v. Waller, 301 F.2d 839, 842 (4th Cir. 1962)). It is not the purpose of a constructive trust to impose punishment but to prevent unjust enrichment. Id. (quoting Sheldon v. Metro-Goldwyn Corp., 309 U.S. 390, 399, 84 L. Ed. 825, 830, 60 S. Ct. 681, 684 (1940)).

The royalties to which Marra and Lund were entitled for the Items sold post termination are computable by application of the terms of their respective license agreements.⁵ However, the amount Debtor invoiced is composed of both a cost of goods sold element and a profit margin for each Item sold. It would be inequitable to deprive the estate of the cost of goods sold portion of each Item because that cost does not represent an expense incurred by Marra and Lund for which restitution is required.⁶ It would also be inequitable to let the estate

⁴ The denominator of the fraction is the original invoice amount (\$758,520.00), Marra’s numerator is its portion of the original invoice (\$417,790.00), and Lund’s numerator is its portion of the original invoice (\$180,040.00). Marra and Lund advocate applying their respective percentages to the settlement amount (\$250,000.00) to arrive at their portions of the constructive trust imposed.

⁵ The Marra agreement is 7% of net sales and the Lund agreement is 5%, yielding \$9625.00 to Marra and \$2875.00 to Lund.

⁶ It is possible that royalty fees are part of the cost of goods sold.

retain the profit element in each Item because, but for the improper use by Debtor of the licenses, both Marra and Lund had opportunity to realize that profit elsewhere by relicensing with other licensees or by direct sale.

Conclusion:

This court holds that a constructive trust in favor of Marra and Lund arose prepetition when Debtor delivered the Items to Toys. The value of the constructive trust is not property of the estate under 11 U.S.C. § 541(d).⁷ The value is comprised of the royalties Marra and Lund would have been entitled to under their respective licensing agreements together with the profit margin that the Debtor would have realized on the gross price per unit after adjustment for the defective product credit allowed Toys. The stipulation of facts does not completely address the valuation issue. An evidentiary hearing is necessary to determine the amounts to which Marra and Lund are entitled. Accordingly, it is

ORDERED:

That Marra Design Associates, Inc. and Lund and Company Inventions, LLC each has a constructive trust in the settlement proceeds held by the Trustee and the amount each is entitled to claim is the sum of the royalty fees computed pursuant to the terms of their respective license agreements and the per unit profit attributable to each of the Items sold to

⁷ “Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor’s legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.” 11 U.S.C. § 541(d) (2006).

Toys R Us, Inc. based upon the invoice amount as adjusted for defective product return (\$417,037.50); and it is

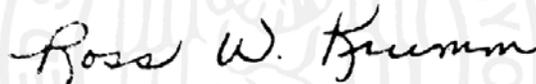
FURTHER ORDERED:

That an evidentiary hearing will be conducted to determine the amount of each constructive trust in the settlement proceeds (\$250,000.00); and it is

FURTHER ORDERED:

That a hearing shall be held by telephone conference call with the court in Harrisonburg, Virginia, on January 24, 2008, at 11:30 a.m. using the call in number 540-769-8744, to set a date for the evidentiary hearing.

Copies of this order are directed to be sent to Trustee, William E. Callahan, Jr., Esquire; to Joseph B. Lyle, Esquire, counsel for Marra Design Associates, Inc.; and to David J. Hutton, Esquire, counsel for Lund and Company Inventions, LLC.



Ross W. Krumm

Ross W. Krumm
U. S. Bankruptcy Judge