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Section 541: Property of the Estate

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I. [3.1] INTRODUCTION

The filing of a bankruptcy petition creates a bankruptcy estate. Section 541 of the Bankruptcy Code, 11 U.S.C. §101 *et seq.*, governs what constitutes property of the bankruptcy estate. The bankruptcy estate is the pool of assets that will be used to satisfy the claims of creditors. Generally, all of a debtor's legal and equitable interest in property as of the filing of the bankruptcy petition and commencement of the bankruptcy case becomes property of the bankruptcy estate. 11 U.S.C. §541(a)(1); *Fowler v. Shadel*, 400 F.3d 1016, 1018 (7th Cir. 2005).

Section 541 is divided into several subsections. 11 U.S.C. §541(a) defines what is included as property of the estate, 11 U.S.C. §541(b) defines what is excluded as property of the estate, 11 U.S.C. §541(c) addresses certain contractual provisions that might otherwise prevent property from being transferred to the estate, and 11 U.S.C. §541(d) limits the estate's interest in property to that which is held by the debtor as of the commencement of the case. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub.L. No. 109-8, 119 Stat. 23, added or extensively revised certain sections of the Code, including 11 U.S.C. §§541(b), 541(e), and 541(f). In addition, 11 U.S.C. §346, relating to treatment of certain tax-related interests, has been extensively revised. When applicable, the authors have noted the affected sections herein. Most provisions of the BAPCPA took effect on October 17, 2005, and do not apply to bankruptcy cases commenced prior to this date. If the effective date of a particular provision discussed herein is different from the general effective date, the authors have noted this effective date.

II. [3.2] APPLICABLE LAW

What constitutes property of a bankruptcy estate is a federal question governed by 11 U.S.C. §541; however, whether and to what extent a debtor has any legal or equitable interest in the subject property as of the commencement of the bankruptcy case may be determined under state law. *In re Yonikus*, 996 F.2d 866, 869 (7th Cir. 1993), citing *Butner v. United States*, 440 U.S. 48, 59 L.Ed.2d 136, 99 S.Ct. 914 (1979), and *In re Jones*, 768 F.2d 923 (7th Cir. 1985).

III. SECTION 541(a): PROPERTY INCLUDED IN THE BANKRUPTCY ESTATE

A. [3.3] Section 541(a)(1): Legal and Equitable Interests of the Debtor in Property

The bankruptcy estate consists of all of the debtor's legal and equitable interest in property as of the date the bankruptcy petition is filed. 11 U.S.C. §541(a)(1). The United States Court of Appeals for the Seventh Circuit has adopted a broad view of the scope of what constitutes property of the estate under §541 of the Bankruptcy Code, noting that "every conceivable interest of the debtor, future, nonpossessory, contingent, speculative, and derivative, is within the reach of §541." *In re Yonikus*, 996 F.2d 866, 869 (7th Cir. 1993). The estate includes all of the debtor's property, regardless of geographic location. *In re Simon*, 153 F.3d 991, 996 (9th Cir. 1998), *cert. denied*, 119 S.Ct. 1032 (1999). In addition, §541 includes the debtor's interest in both tangible and intangible property. *Shimer v. Fugazy (In re Fugazy Express, Inc.)*, 114 B.R. 865, 869 (Bankr. S.D.N.Y. 1990), *aff'd*, 124 B.R. 426 (S.D.N.Y. 1991).

While §541 is intended to be inclusive of all of the debtor's interest in property as of the commencement of the bankruptcy case, the estate is limited to only such legal and equitable interests that the debtor actually possessed as of this date, no more and no less. *Berger, Shapiro & Davis, P.A. v. Haeling (In re Foos)*, 183 B.R. 149, 155 – 156 (Bankr. N.D.Ill. 1995). The commencement of a bankruptcy case does not increase or decrease a debtor's interest in property; rather, "it merely changes the party who holds the interest." *In re Sanders*, 969 F.2d 591, 593 (7th Cir. 1992).

1. [3.4] Effect of Conversion of Bankruptcy Case

When a bankruptcy case converts from a case for relief under Chapter 11 or 13 of the Bankruptcy Code to a liquidation under Chapter 7 of the Code, the court will look to the filing of the original Chapter 11 or 13 bankruptcy petition to determine what constitutes property of the Chapter 7 estate. *Patrick A. Casey, P.A. v. Hochman*, 963 F.2d 1347, 1350 (10th Cir. 1992).

2. Application to Specific Types of Property or Interests of the Debtor

a. [3.5] Exempt Property

Certain property may be excluded from the bankruptcy estate under 11 U.S.C. §541(b) (see the discussion in §§3.24 – 3.26 below) or exempted from the estate under 11 U.S.C. §522. *In re Yonikus*, 996 F.2d 866, 869 (7th Cir. 1993). Exemptions under §522 apply only to individual debtors, not corporate debtors, and this section will be covered in more detail in a new IICLE title on consumer bankruptcy expected in mid to late 2006. Even property that is entitled to be exempted is initially regarded as estate property until it is claimed and distributed as exempt. *In re Doyle*, 209 B.R. 897, 905 (Bankr. N.D.Ill. 1997).

b. [3.6] Insurance

As a general rule, insurance policies that provide coverage for the debtor's liability are property of the bankruptcy estate. *In re Shondel*, 950 F.2d 1301, 1305 (7th Cir. 1991); *Grochocinski v. Allstate Insurance Co. (In re Lyckberg)*, 310 B.R. 881, 888 (Bankr. N.D.Ill. 2004). This includes policies purchased by the debtor covering its directors and officers (*Maxwell v. Megliola (In re marchFIRST, Inc.)*, 288 B.R. 526, 529 (Bankr. N.D.Ill. 2002)), fire protection (*Grochocinski, supra*, 310 B.R. at 888, citing *In re Denny*, 285 B.R. 184 (Bankr. M.D.N.C. 2002)), and *In re Hoffpauir*, 258 B.R. 447 (Bankr. D. Idaho 2001)), and life insurance (*In re Doyle*, 209 B.R. 897, 906 (Bankr. N.D.Ill. 1997)), but whether the proceeds of these insurance policies are property of the estate is a separate issue and is addressed in 11 U.S.C. §541(b)(1) (see §3.24 below).

c. [3.7] Encumbered Property

Under 11 U.S.C. §541, a debtor has an interest in property even if the property is fully encumbered by liens and the debtor has only an equitable or possessory interest. *In re VanZant*, 210 B.R. 1011, 1016 (Bankr. S.D.Ill. 1997).

d. [3.8] *Contracts*

Generally, the estate inherits all of the rights and obligations of the debtor under contracts as of the commencement of the bankruptcy case, including leases, franchise agreements, and joint venture agreements. *In re Holywell Corp.*, 913 F.2d 873, 881 (11th Cir. 1990).

e. [3.9] *Letters of Credit*

Letters of credit and their proceeds are not property of a debtor's estate. *Shanri Holdings Corp. v. Kmart Corp. (In re Kmart Corp.)*, 297 B.R. 525, 529 (N.D.Ill. 2003). Accordingly, when the account party is a bankrupt debtor, the beneficiary of a letter of credit is not stayed from drawing on the letter of credit. 297 B.R. at 529 – 530 (“It is axiomatic that letters of credit represent obligations of the bank completely independent of the underlying transaction. . . . General principles of bankruptcy reinforce the independence of the bank’s obligation to honor drafts in a letter-of-credit transaction from its rights against its now insolvent customer.”), quoting *Duplitronics, Inc. v. Concept Design Electronics & Manufacturing, Inc. (In re Duplitronics, Inc.)*, 183 B.R. 1010, 1015 (Bankr. N.D.Ill. 1995). Once the letter of credit has been drawn down, the bank has a claim against the debtor for the amount of the draw and is entitled to be indemnified by the debtor. 297 B.R. at 530. The beneficiary’s right to retain the proceeds is then governed by the underlying agreement between the beneficiary and the debtor. *Praedium II Broadstone, LLC v. Wall Street Strategies, Inc.*, No. 04 Civ. 3880 (WHP), 2004 U.S. Dist. LEXIS 23308 (S.D.N.Y. Nov. 18, 2004).

f. [3.10] *Tax Refunds and Credits*

Generally, tax refunds based on earnings or losses prior to the filing of the bankruptcy petition are part of the bankruptcy estate, even if the refund is received post-petition. *In re Moody*, 241 B.R. 238, 241 – 242 (Bankr. M.D.Fla. 1999). See also *Samson v. Connor (In re Connor)*, 288 B.R. 807, 809 (Bankr. S.D.Ill. 2002). Additionally, the following tax-related interests constitute property of the estate:

1. net operating loss carryover;
2. charitable contributions carryover;
3. recovery of tax benefit items;
4. capital loss carryovers;
5. basis, holding period, and character of assets;
6. method of accounting. *Official Committee of Unsecured Creditors of Antonelli v. United States (In re Antonelli)*, 150 B.R. 364, 366 (Bankr. D.Md. 1992), citing 11 U.S.C. §346(a) and 26 U.S.C. §1398(g).

NOTE: *In re Antonelli* was decided under §346(a) of the Bankruptcy Code prior to its extensive revision by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub.L. No. 109-8, 119 Stat. 23.

g. [3.11] Deposits

As a general rule, the amounts held in a debtor's accounts as of the filing of a bankruptcy petition are property of the estate. There are exceptions to this general rule, as noted in §§3.12 – 3.15 below.

(1) [3.12] Agency

If a debtor collects amounts as agent for third parties and holds these funds in a segregated account, the funds may not be property of the debtor's estate. *Greenfield Direct Response, Inc. v. Adco List Management (In re Greenfield Direct Response, Inc.)*, 171 B.R. 848, 857 (Bankr. N.D.Ill. 1994). See also the discussion of 11 U.S.C. §541(d) in §3.29 below.

(2) [3.13] Security Deposit

If a debtor holds funds transferred to the debtor under a lease or other agreement as a security deposit and these funds are not segregated from the debtor's general funds, the funds are property of the debtor's estate. *Hechinger Liquidation Trust v. Monga (In re Hechinger Investment Company of Delaware, Inc.)*, 299 B.R. 340, 342 (Bankr. D.Del. 2003).

(3) [3.14] Escrow Funds

As a general rule, funds transferred by the debtor and held in escrow for the benefit of a party other than the debtor are not property of the estate once the conditions of the escrow are satisfied. *Federal Deposit Insurance Corp. v. Knostman*, 966 F.2d 1133, 1142 (7th Cir. 1992). However, until the conditions of the escrow are satisfied, the debtor may have a continuing beneficial interest in the funds, and this interest is property of the estate. *In re Rosenshein*, 136 B.R. 368, 373 (Bankr. S.D.N.Y. 1992) (comparing continuing interest in escrow funds to continuing interest held by debtor in accounts receivable pledge as security for loan as debtor has continuing interest in any surplus collections). See also the discussion of 11 U.S.C. §541(d) in §3.29 below.

(4) [3.15] Tax Accounts

If a debtor has set aside funds in a real estate tax account that was required under a commercial nonresidential lease when the only requirement imposed by the lease was that the debtor had to make monthly deposits into an interest-bearing account so as to have sufficient funds available to make necessary tax payments and the debtor is not otherwise limited in its access to account funds, these funds are property of the estate. *In re Handy Andy Home Improvement Centers, Inc.*, 196 B.R. 87, 92 (Bankr. N.D.Ill. 1996).

h. [3.16] Bonds

Real estate that is the subject of a supersedeas bond trust agreement is not property of the estate to the extent that it secures otherwise nondischargeable damages. *Gnidovec v. Alwan (In re Alwan Brothers Co.)*, 105 B.R. 886, 895 (Bankr. C.D.Ill. 1989).

i. [3.17] *Licenses and Permits*

The debtor's interests in licenses and permits are generally considered property of the estate even when these licenses or permits are considered a privilege and not a property right under applicable non-bankruptcy law. *Professional Sales Corp. v. United States (In re Professional Sales Corp.)*, 48 B.R. 651, 660 (Bankr. N.D.Ill.), *vacated on other grounds*, 56 B.R. 753 (N.D.Ill. 1985). See also *In re National Cattle Congress, Inc.*, 179 B.R. 588, 593 (Bankr. N.D. Iowa 1995).

j. [3.18] *Retainers*

While the majority view is that all pre-petition retainers transferred by the debtor to its attorney are property of the estate, the United States Bankruptcy Court for the Northern District of Illinois has held that this determination depends on the type of retainer given. *In re Production Associates, Ltd.*, 264 B.R. 180, 189 (Bankr. N.D.Ill. 2001). If the retainer is a "classic retainer," such that the retainer is made in return for the attorney's promise to be available but not to cover any specific legal services and, accordingly, is to be earned when paid, the retainer is not property of the estate under 11 U.S.C. §541. 264 B.R. at 188 – 189. *But see In re NBI, Inc.*, 129 B.R. 212, 223 (Bankr. D.Colo. 1991) (adopting per se rule barring classic retainers in bankruptcy).

B. [3.19] Section 541(a)(2): Community Property

11 U.S.C. §541(a)(2) governs the circumstances in which community property held between the debtor and the debtor's spouse constitutes property of the estate. Section 541(a)(2) will be covered in more detail in a new IICLE title on consumer bankruptcy expected in mid to late 2006.

C. [3.20] Sections 541(a)(3) and 541(a)(4): Property Recovered or Preserved for Benefit of or Ordered Transferred to Estate

11 U.S.C. §§541(a)(3) and 541(a)(4) bring into the bankruptcy estate property recovered by the trustee or otherwise preserved for the benefit of the estate or ordered transferred to the estate under several other sections of the Bankruptcy Code, including, without limitation, the following:

1. fees disgorged from debtor's counsel pursuant to 11 U.S.C. §329(b)(1);
2. damages based on collusion between bidders at a sale conducted in accordance with 11 U.S.C. §363(n);
3. property received from a prepetition custodian of the debtor's assets, such as an assignee for the benefit of creditors or other prepetition receiver or liquidator of the debtor's assets, pursuant to 11 U.S.C. §543;
4. property or proceeds from avoidance actions pursuant to 11 U.S.C. §550;
5. any interest in property recovered from general partners of the debtor pursuant to 11 U.S.C. §723;

6. liens under 11 U.S.C. §510(c) securing claims that are equitably subordinated, to the extent such liens are transferred to the estate pursuant to 11 U.S.C. §510(c)(2); and
7. any transfer avoided under 11 U.S.C. §522, §544, §§547 – 549, or §724(a), or any lien void under 11 U.S.C. §506(d), but only with respect to property of the estate.

D. [3.21] Section 541(a)(5): Entitlements Within 180 Days After Filing Petition

11 U.S.C. §541(a)(5) brings into the estate certain assets that the debtor receives within 180 days after filing the bankruptcy petition. Specifically, §541(a)(5) makes property of the estate assets that would have been property of the estate had the debtor had an interest in them at the commencement of the case and in which the debtor subsequently acquires an interest (1) by bequest, devise, or inheritance; (2) by virtue of a property settlement or other divorce decree; or (3) as a beneficiary of a life insurance policy or death benefit plan. In general, these entitlements affect individual debtors, not business debtors, and this subject will be covered in more detail in a new IICLE title on consumer bankruptcy expected in mid to late 2006. It is interesting to note that while life insurance proceeds that the debtor as beneficiary becomes entitled to within 180 days of filing the bankruptcy petition constitute property of the estate, whether these proceeds are also properly claimed as exempt may be an issue of state law. *In re Doyle*, 209 B.R. 897, 906 (Bankr. N.D.Ill. 1997).

E. [3.22] Section 541(a)(6): Proceeds from Estate Property

11 U.S.C. §541(a)(6), like 11 U.S.C. §541(a)(5), also expands the definition of “property of the estate” to include certain property interests that are acquired after the commencement of the case; in particular, proceeds, products, offspring, rents, or profits resulting from property that is otherwise part of the estate are considered to be property of the estate. *See also In re Taronji*, 174 B.R. 964, 969 (Bankr. N.D.Ill. 1994). For example, the proceeds of a post-petition sale of the debtor’s assets constitute property of the estate. *In re CXM, Inc.*, 307 B.R. 94, 103 (Bankr. N.D.Ill. 2004) (purchaser’s request for payment of breakup fee out of sale proceeds denied because proceeds constituted property of estate and were subject to secured creditor’s superior lien).

Specifically excluded by §541(a)(6) are proceeds that an individual debtor receives as compensation for services performed post-petition. *In re Haynes*, 679 F.2d 718, 719 (7th Cir. 1982). Whether this exclusion applies (and to what degree) in cases involving sole proprietorships or medical practices has been the subject of some discussion. *See, e.g., In re Prince*, 85 F.3d 314, 323 (7th Cir. 1996). As a general rule, a professional’s skills, training, and license do not constitute property of the estate because they are uniquely personal and cannot be transferred. However, the professional’s goodwill and client relationships are property of the estate. *Id.*

NOTE: Following the amendments of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub.L. No. 109-8, 119 Stat. 23, the Bankruptcy Code provides that property and earnings acquired by an individual Chapter 11 debtor (not a corporate debtor) after the filing of the bankruptcy petition and prior to the closing, dismissal, or conversion of the case to a case under Chapter 7, 12, or 13 will constitute property of the estate. 11 U.S.C.

§1115. For further discussion of consumer issues, practitioners may wish to review *Major Consumer Bankruptcy Effects of the 2005 Reform Legislation* (Apr. 2005), an article prepared by Judge Eugene R. Wedoff, Chief Bankruptcy Judge for the United States Bankruptcy Court for the Northern District of Illinois, and that is available at the Northern District's Web site at www.ilnb.uscourts.gov/JudgeWedoff/WedoffOpinions.htm (case sensitive).

F. [3.23] Section 541(a)(7): Interests Acquired Post-Petition by the Estate

The estate of a corporate debtor also includes the debtor's business, and, if the debtor continues to conduct business post-petition (as permitted under 11 U.S.C. §§721 and 1108), the operations of the debtor may lead to the acquisition of property post-petition, such as, for example, in the form of raw materials or inventory. Under 11 U.S.C. §541(a)(7), this property becomes property of the estate, even though it is acquired post-petition.

IV. SECTION 541(b): PROPERTY EXCLUDED FROM THE BANKRUPTCY ESTATE

A. [3.24] Section 541(b)(1): Property or Power Benefiting Other Entity

11 U.S.C. §541(b)(1) excludes from the estate any power held by the debtor as of the commencement of the case that is exercised solely for the benefit of another entity, such as property over which the debtor is a trustee. *Dally v. Bank One, Chicago, N.A. (In re Dally)*, 202 B.R. 724, 727 (Bankr. N.D.Ill. 1996).

B. [3.25] Section 541(b)(2): Leases That Terminated Under Their Terms Prepetition

11 U.S.C. §541(b)(2) excludes from the bankruptcy estate any interest a debtor as lessee may have in a nonresidential real property lease that terminates by its terms prior to the filing of the bankruptcy petition. This subsection further provides that any interest a debtor as lessee may have in a nonresidential real property lease that terminates by its terms after the filing of the petition will cease, upon this termination, to be property of the bankruptcy estate.

C. [3.26] Sections 541(b)(3), 541(b)(4), and 541(b)(9)

11 U.S.C. §§541(b)(3), 541(b)(4), and 541(b)(9) generally exclude the following interests of the debtor from the estate:

1. the eligibility of the debtor to participate in the Higher Education Act of 1965, Pub.L. No. 89-329, 79 Stat. 1219;
2. certain interests of the debtor in liquid or gaseous hydrocarbons; and
3. proceeds of certain sales of money orders.

These provisions are either too limited in scope for a general treatise or apply to individual bankruptcy cases, which will be covered in more detail in a new IICLE title on consumer bankruptcy expected in Summer 2006.

NOTE: There were significant changes to §541(b) under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub.L. No. 109-8, 119 Stat. 23, that relate to the protection of certain education and retirement savings. 11 U.S.C. §541(b)(7)(A) was added to exclude from the bankruptcy estate any amount withheld by an employer from the wages of employees as contributions and any amount received by an employer for payment as contributions from employees to (1) employee benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §1001, *et seq.*; (2) deferred compensation plans under §457 of the Internal Revenue Code, 26 U.S.C. §457; (3) tax-deferred annuities under §403(b) of the Internal Revenue Code, 26 U.S.C. §403(b); and (4) a health insurance plan regulated by state law. In addition, 11 U.S.C. §541(b)(8) was added to exclude from the estate the debtor's interest in pawned property under circumstances in which the property was pledged for a loan to a licensed pawn broker and (1) the property is in the possession of the pawn broker, (2) the debtor has no obligation to pay back the loan, and (3) neither the debtor nor the trustee has exercised any right to redeem under 11 U.S.C. §108(b) and applicable non-bankruptcy law.

V. SECTION 541(c): RESTRICTED OR CONDITIONED INTERESTS

A. [3.27] Sections 541(c)(1)(A) and 541(c)(1)(B)

11 U.S.C. §§541(c)(1)(A) and 541(c)(1)(B) provide that a debtor's interest in property will become property of the estate regardless of any applicable transfer restrictions or provisions that terminate a debtor's interest in property based on the financial condition of the debtor, the commencement of a bankruptcy case under the Bankruptcy Code, or the taking of possession by a trustee or custodian under the Code or, prior to the commencement of the case, under contract or non-bankruptcy law.

B. [3.28] Section 541(c)(2)

In contrast to §541(c)(1), 11 U.S.C. §541(c)(2) provides that a restriction of the debtor's beneficial interest in a trust under applicable non-bankruptcy (generally state) law is enforceable, and this interest is not property of the estate. This exclusion is to be narrowly construed, and some courts have held that it applies only to traditional spendthrift trusts as defined by state law. *In re Gifford*, 93 B.R. 636, 638 (Bankr. N.D.Ind. 1988), citing, *inter alia*, *Firestone v. Metropolitan Life Insurance Co.* (*In re Di Piazza*), 29 B.R. 916 (Bankr. N.D.Ill. 1983).

VI. [3.29] SECTION 541(d) PROPERTY IN WHICH DEBTOR HOLDS ONLY LEGAL TITLE

The estate receives the same interest as the debtor held in the subject property as of the commencement of the bankruptcy case. Accordingly, if "the debtor holds bare legal title without an equitable interest, the estate acquires bare legal title without any equitable interest." *Berger, Shapiro & Davis, P.A. v. Haeling (In re Foos)*, 183 B.R. 149, 156 (Bankr. N.D.Ill. 1995), quoting *In re N.S. Garrott & Sons*, 772 F.2d 462, 466 (8th Cir. 1985). The legislative history of 11 U.S.C. §541(d) is clear that this section was originally intended to address the special concerns of the

secondary mortgage market to ensure that if a seller retained the original mortgage notes and related documents for the purposes of servicing the mortgage, these mortgage notes would not become property of the estate, and the trustee would be required to turn over these mortgage notes to the purchaser. S.Rep. No. 989, 95th Cong., 2d Sess. 83 – 84 (1978). *See also Belisle v. Plunkett*, 877 F.2d 512, 515 – 516 (7th Cir. 1989). However, §541(d) is not limited to secondary mortgage market cases. 877 F.2d at 516 (“statutes often create rules that reach beyond the immediate concerns that spawned them”). Courts have generally recognized that §541(d) describes “the classic trust situation,” including situations in which the court may impose a constructive trust. *Dunhan v. Kisak (In re Kisak)*, No. 96-41075, 1998 Bankr. LEXIS 1903 (Bankr. S.D.Ill. Feb. 27, 1998).

VII. [3.30] SECTION 541(f)

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub.L. No. 109-8, 119 Stat. 23, added 11 U.S.C. §541(f), which allows any property of the estate of a nonprofit debtor under §501(c)(3) of the Internal Revenue Code, 26 U.S.C. §501(c)(3), to be transferred to an entity that is not such a corporation, but only under the same conditions that would be applicable if the debtor was not in bankruptcy. Note that this provision of the BAPCPA is effective in cases pending on or after April 20, 2005, the date of enactment of the Act.