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The Strong Arm Clause Outmuscles the Constructive Trust- *In re General Coffee Corp.: City National Bank of Miami v. General Coffee Corp*

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CASENOTES

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Most of the writers of monographs on the subject of priorities and many of the judges appear to think that there is something essentially commendable in giving one claimant priority over others. This is a peculiar psychological phenomenon.

Auston Wakeman Scott

I. THE FACTS

General Coffee Corporation (“General Coffee”) is a Florida corporation that purchases, processes, and sells coffee. In March of 1982, General Coffee expanded its business by purchasing the assets of the Chase & Sanborn Company from Standard Brands, Inc. The purchased assets included a fully equipped processing plant in New Orleans, Louisiana, a substantial inventory of coffee, and all of the licenses and trademarks of Chase & Sanborn. The contract required payment of three million dollars cash, a note for four and

* The author of this casenote was employed as a summer associate by the law offices of Alan J. Kluger, special litigation counsel for General Coffee Corp. The clerkship ended prior to the writing of this casenote.

three-quarters million dollars, and a cash amount equivalent to the fair market value of Standard Brands's inventory of coffee one day prior to the closing, an amount subsequently determined to be \$6,488,011.00.¹

General Coffee obtained the funds to purchase the inventory by the following fraudulent scheme. Camilio Bautista, simultaneously an officer of City National Bank and Dominio Investments, Ltd., a company which controlled General Coffee, advised City National Bank to purchase a Eurodollar certificate of deposit in the amount of eight million dollars from Banco Exterior, S.A. (Panama). Bautista then, without authorization, but acting with apparent authority as an officer of City National Bank, pledged the certificate of deposit to Banco Exterior as collateral for an eight million dollar loan for Dominio Investments. Dominio Investments transferred the funds to General Coffee through an intricate series of bank transactions. General Coffee used the eight million dollars to purchase Chase & Sanborn's coffee inventory at the time of the takeover. Dominio subsequently defaulted on the loan payments causing Banco Exterior to seize City National Bank's certificate of deposit.²

In May of 1983, before City National Bank filed suit, General Coffee petitioned for reorganization and protection from its creditors under chapter eleven of the Bankruptcy Code.³ On January 13, 1984, City National Bank of Miami and City National Bank Corporation (collectively referred to as "City National Bank") initiated proceedings against General Coffee in both the United States Bankruptcy Court⁴ and the Dade County Circuit Court.⁵ They sought imposition of a constructive trust over the assets obtained by General Coffee in the purchase of Chase & Sanborn. They filed the petitions on January 13, 1984. On February 3, 1984, the presiding judge⁶ in the bankruptcy proceeding yielded to the jurisdiction of the circuit court and dismissed City National Bank's

1. City Nat'l Bank of Miami v. General Coffee Corp. (*In re General Coffee Corp.*), 41 Bankr. 781, 782-83 (Bankr. S.D. Fla. 1984).

2. *Id.* City National Bank sued Banco Exterior in a separate proceeding alleging wrongful conversion of the certificate of deposit. City Nat'l Bank of Miami v. Banco Exterior de Espana, S.A., No. 83-20817 CA-21 (Fla. 11th Cir. Ct. 1983).

3. *In re General Coffee Corp.*, Debtor (S.D. Fla. 1984) (Case No. 84-00889).

4. City Nat'l Bank of Miami v. General Coffee Corp. (*In re General Coffee Corp.*), BKC Adv. No. 84-0028-BKC-TCB-A (Bankr. S.D. Fla. 1984).

5. City Nat'l Bank of Miami v. General Coffee Corp., No. 84-05304 CA-29 (Fla. 11th Cir. Ct. 1984).

6. The Honorable Thomas C. Britton presided.

complaint without prejudice. He also stayed the General Coffee reorganization proceedings pending determination of the issues in the circuit court. On July 30, 1984, however, the judge vacated his Order of Dismissal and scheduled a hearing on the adversary proceedings.⁷ Shawmut Boston International Banking Corporation, a major creditor of General Coffee, intervened and supported the position of General Coffee.

II. BRIEF DISCUSSION

City National Bank sought to obtain the assets which General Coffee acquired from its purchase of Chase & Sanborn. It relied on a theory of constructive trust. In Florida, a constructive trust arises only when a court of competent jurisdiction declares the trust to exist.⁸ Under the United States Bankruptcy Code, the rights of the trustee in bankruptcy (the rights of a perfect hypothetical lienholder) arise *upon commencement* of the bankruptcy proceeding.⁹ Therefore, the rights of the Trustee attach prior to the time when creation of a trust becomes possible. Accordingly, the court *held*: General Coffee's interest as the trustee in bankruptcy was superior to City National Bank's interest as the beneficiary of a constructive trust. *City National Bank of Miami v. General Coffee Corporation (In re General Coffee Corp.)*, 41 Bankr. 781 (Bankr. S.D. Fla. 1984). If affirmed on appeal, this decision will have far reaching effects on the practice of bankruptcy law in the state of Florida. The constructive trust remedy will no longer be available to creditors as an aid in regaining fraudently taken assets, as long as the debtor files for the protection of a bankruptcy court prior to the time the creditor files suit.

7. Judge Britton's decision to accept jurisdiction over the matter may have been influenced by the fact that proceedings in the Eleventh Circuit Court in and for Dade County would take several months or longer. Since the subject matter of the controversy included the assets of General Coffee, any possible reorganization plan had to be stayed pending the outcome of the adversary proceeding. If the reorganization plan had been instituted prior to the decision in the adversary proceeding, and City National Bank had subsequently prevailed, the assets that City National Bank would have been entitled to may have been already distributed to creditors or otherwise utilized in the corporate reorganization.

8. See *Palmland Villas I Condominium Assoc. v. Taylor*, 390 So. 2d 123, 124-25 (Fla. 4th DCA 1980); see also *infra* text accompanying notes 20-22 (describing Florida constructive trust case law).

9. 11 U.S.C. § 544(a) (1978) (emphasis added).

III. ANALYSIS

A. *Constructive Trust Defined*

A constructive trust is not a trust at all, but a tool of equity. To promote an equitable result, the courts apply a legal fiction when one unjustly holds the property of another. The court fictitiously deems the property to be held in trust. The court deems the party unjustly holding the property to be the trustee, and the party to whom the property justly belongs to be the beneficiary.¹⁰

It is helpful to contrast constructive trusts with express and resulting trusts. An *express trust* is a fiduciary relationship that arises because the parties manifest an intent to create a trust. The trustee owes equitable duties to the beneficiary of the trust and handles the trust property on behalf of the beneficiary.¹¹ A *resulting trust* arises by operation of law when the parties intend to create an express trust but fail, due to some technicality.¹² Thus, in both express and resulting trusts, the parties must *intend* to create a trust relationship.

A *constructive trust*, on the other hand, is not based upon the intention of the parties. It is imposed to prevent one person from being unjustly enriched at the expense of another.¹³ The constructive trust, unlike the express trust or resulting trust, is a remedial

10. See G. BOGERT, *THE LAW OF TRUSTS & TRUSTEES* § 471 (2d ed. 1978).

In *Beatty v. Guggenheim Exploration Co.*, Judge Cardozo explained:

A constructive trust is the formula through which the conscience of equity finds expression. When property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest, equity converts him into a trustee

. . . . A court of equity in declaring a constructive trust is bound by no unyielding formula. The equity of the transaction must shape the measure of relief.

225 N.Y. 380, 386, 389, 122 N.E. 378, 380-381 (1919). See also *Hallam v. Gladman*, 132 So. 2d 198 (Fla. 2d DCA 1961) (Florida court adopting similar definition). See generally 1 PALMER, *THE LAW OF RESTITUTION* § 1.3 (1978) (history of constructive trusts).

11. 5 A. SCOTT, *THE LAW OF TRUSTS* § 462.1 (3d ed. 1967).

12. 4 A. SCOTT, *THE LAW OF TRUSTS* § 404.1 (2d ed. 1956).

In *Grapes v. Mitchell*, the Supreme Court of Florida explained:

[A] resulting trust is simply a status that automatically arises by operation of law out of certain circumstances. In the creation of a resulting trust, it is essential that the parties actually intend to create the trust relationship but failed to execute documents or establish adequate evidence of the intent. In a resulting trust, a vital element is the intention which will be presumed from the facts A resulting trust is one which exists because of inferred or presumed intent of a property owner, as distinguished from a trust based on intent which is directly and clearly expressed.

159 So. 2d 465, 467 (Fla. 1963).

13. See *supra* note 10 and accompanying text.

device and not a substantive institution.¹⁴

City National Bank did not allege the existence of a resulting or express trust in the bankruptcy court; they could not have supported such an allegation because the parties never *intended* to create a trust relationship. They relied instead on a theory of constructive trust.¹⁵ The outcome of *General Coffee* on appeal will depend on the appellate court's determination of *when* a constructive trust is created.

B. Constructive Trust - Two Theories of Creation

There are two views regarding when a constructive trust comes into existence.¹⁶ In the majority of states, a constructive trust arises when a fraudulent transaction gives rise to the necessity of the imposition of a constructive trust.¹⁷ In other states, a constructive trust arises only after the beneficiary asks a court of compe-

14. See Pound, *The Progress of the Law, 1918-1919 Equity*, 33 HARV. L. REV. 420, 421 (1920). See generally, Costigan, *The Classification of Trusts as Express, Resulting and Constructive*, 27 HARV. L. REV. 437 (1914) (detailed development of the various trusts, their creation and distinctions).

In explaining the differences among express, resulting, and constructive trusts, the Supreme Court of Florida stated:

As distinguished from an express trust, there are two types of so-called implied trusts. One is known as a "resulting trust". The other is known as a "constructive trust". Although some confusion exists as to the distinction between the two, it appears to us that our own decisions make the differences clear and dispose of the confusing elements. A resulting trust is simply a status that automatically arises by operation of law out of certain circumstances. A constructive trust is a remedy which equity applies in order to do justice. In the creation of a resulting trust it is essential that the parties actually intend to create the trust relationship but fail to execute documents or establish adequate evidence of the intent

By contrast, a constructive trust is a relationship adjudicated to exist by a court of equity based on particular factual situations created by one or the other of the parties. The element of intent or agreement either oral or written to create the trust relationship is totally lacking. The trust is "constructed" by equity to prevent an unjust enrichment of one person at the expense of another as the result of fraud, undue influence, abuse of confidence or mistake in the transaction that originates the problem.

Wadlington v. Edwards, 92 So. 2d 629, 631 (Fla. 1957).

15. *General Coffee Corp.*, 41 Bankr. at 782.

16. See BOGERT, *supra* note 10, at § 472.

17. See, e.g., *Shearer v. Barnes*, where the court stated:

The trust, in such a case, is not created by the court, but is merely declared by the court to have arisen when a certain state of facts is shown. The court may or may not enforce the trust, according to the equities of the parties when its aid is sought; but the trust itself is a creature of equity, born of and *contemporaneously* with the wrongful diversion of the beneficiaries' funds. (Emphasis added).

118 Minn. 179, 188, 136 N.W. 861, 864 (1912).

tent jurisdiction to impose the trust, and the court declares one to exist.¹⁸ The theory underlying the latter viewpoint is that a constructive trust is not a trust at all, but merely a *remedy* which a court may utilize when necessary to provide an equitable result.¹⁹

The State of Florida adheres to the minority position. In *Palmland Villas I Condominium Association v. Taylor*,²⁰ a seller fraudulently conveyed real property to a development corporation to be used for recreational purposes. The conveyance was duly recorded. Subsequently, claimants recorded a tax lien and three judgments against the property. The liens were enforceable only if they arose prior to creation of the constructive trust. The Florida Fourth District Court of Appeal held that the liens attached to the real property prior to the creation of the constructive trust because the constructive trust did not arise until the court declared it to exist, approximately three years later.²¹ The beneficiaries of the constructive trust took the position that the tax and judgment liens never attached because the property was a trust asset from the time of the earlier (fraudulent) conveyance. The court stated:

The result in this case turns upon the answer to the question, when does a constructive trust come into existence. We determine that a constructive trust comes into existence on the date of the order or judgment of a court of competent jurisdiction declaring that a series of events has given rise to a constructive trust. . .

. . . Therefore there was no trust in existence when the liens at-

18. See, e.g., *Edmonson v. Bradford-White Corp. (In re Tinnell Traffic Serv.)*, 41 Bankr. 1018, 1021 (Bankr. M.D. Tenn. 1984) (bankruptcy court applying Tennessee state law determined that "[s]ince constructive trusts are judge-created equitable remedies, the trust does not come into existence until imposed by a court of equity."); see also *Stoehr v. Miller*, 296 F. 414, 427 (2d Cir. 1923).

19. See *In re Tinnell Traffic Services*, 41 Bankr. at 1021; see also *International Refugee Org. v. Maryland Drydock Co.*, where the Fourth Circuit stated:

A constructive trust is not a title to or lien upon property but a mere remedy to which equity resorts in granting relief against fraud; and it does not exist so as to affect the property held by a wrongdoer until it is declared by a court of equity as a means of affording relief.

179 F.2d 284, 287 (4th Cir. 1950).

Certain courts that support this "remedy versus trust" distinction have found it significant that constructive trusts are dealt with in the Restatement of Restitution rather than the Restatement of Trusts. See, e.g., *Papazian v. American Steel & Wire Co.*, 155 F. Supp. 111, 119 (N.D. Ohio 1957).

20. 390 So. 2d 123 (Fla. 4th DCA 1980). The Supreme Court of Florida has never ruled on this issue.

21. *Id.* at 124.

tached. Imposition of a constructive trust by the order of January 5, 1979, [declaring the real property to be held in constructive trust] could have no effect on the validity or priority of those liens.²²

As stated above, the determination of *when* a constructive trust arises is crucial to the outcome of the *General Coffee* litigation.

C. *The Strong Arm Clause*

When a lender contemplates extending credit, the lender searches the state records to discover whether any liens exist upon the assets of the potential loan recipient because the lender's interest is subordinate to any pre-existing interests.²³ A lender's greatest fear is that of a "secret lien." Where a secret lien exists, a lender may extend credit to a borrower feeling assured that the loan is supported by adequate collateral but may discover, upon default, that there are other creditors with previous, unrecorded claims that have priority to the debtor's assets. One potential consequence of giving priority to previous, *unrecorded* liens would be to discourage the extension of credit.

Recognizing the potential danger to American business, Con-

22. *Id.* at 124-25. The Florida Fifth District Court of Appeal cited *Palmland Villas I* as precedent in *Cohen v. Hardman*, 416 So. 2d 498 (Fla. 5th DCA 1982). In *Cohen*, James Savage was the principal on two bail bonds posted by Dependable Insurance Co. through its surety agent, Leroy Hardman, in the amount of \$5,250.00. Savage failed to appear in court and the bonds were discharged. Armond Savoie, allegedly involved with Savage, indemnified Hardman.

Approximately six months later, Savage was rearrested. He hired Meredith Cohen as his attorney. Pursuant to a plea bargain, Savage pled *nolo contendere*. One of the conditions of the bargain was that the state remit the forfeited bonds. Savage, alleging that he reimbursed Hardman, sought remission of the forfeited bonds pursuant to the negotiated plea. The court released the funds to Savage, through his attorney, Cohen. Cohen retained \$2,000.00 for attorney fees, paid \$100.00 in court costs, and transferred the remaining \$3,150.00 to Savage. Pursuant to the negotiated plea, Savage moved out of state and assumed a new identity. *Id.* at 499.

Subsequently, Hardman learned of the remission of the bonds, and alleging that Savage never reimbursed him, filed a motion to set aside the remission. The court added Savoie as a necessary party. The trial court set aside the remission, and ordered Cohen to place the funds with the court pending determination of who was entitled to them. *Id.* at 499-500. The Florida Fifth District Court of Appeal, in reversing the order of the trial court, held that it was error for the trial court to order Cohen to place his own funds with the court (the remitted funds had already been discharged to Savage) prior to a determination of liability. The court stated, "This premature action is similar to ordering the imposition of a constructive trust on a person's assets before there has been a determination that the trust should be imposed." *Id.* at 500. Thus, the holding of *Cohen v. Hardman* does not directly support *Palmland*, but rather implies *Palmland* to be the correct Florida law.

23. U.C.C. § 9-301 (1978).

gress enacted what is commonly known as the "strong arm clause." The clause originally made its appearance in 1910 as an amendment to section 47a(2) of the then existing Bankruptcy Act.²⁴ The strong arm clause is currently found in section 544(a) of the Bankruptcy Code.²⁵ It protects the trustee in bankruptcy from secret liens by endowing him with the status of a perfected lienholder from the date of the commencement of the bankruptcy proceeding. The legislative history of section 544 explains:

[The strong arm clause] gives the trustee the rights of a creditor on a simple contract with a judicial lien on the property of the debtor as of the date of the petition; of a creditor with a writ of execution against the property of the debtor unsatisfied as of the date of the petition; and a bona fide purchaser of the real property of the debtor as of the date of the petition.²⁶

Courts deem previously unrecorded (and unperfected) interests to arise subsequent to the interests of the trustee in bankruptcy,²⁷ enabling the trustee to defeat the claims of secret lienholders. The size of the debtor's estate which is to be distributed among the debtor's creditors is thus increased.²⁸

24. 4B COLLIER ON BANKRUPTCY § 70.47 (14th ed. 1978) (history of the strong arm clause).

25. 11 U.S.C. § 544(a) (1978). Section 544(a) provides:

The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—

1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained a judicial lien, whether or not such a creditor exists;

2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; and

3) a bona fide purchaser of real property from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser at the time of the commencement of the case, whether or not such a purchaser exists.

Id.

26. H.R. REP. No. 95-595, 95th Cong., 1st Sess. 370 (1977).

27. See U.C.C. § 9-301 (1978).

28. 4 COLLIER ON BANKRUPTCY § 544.01 (15th ed. 1984). See *In re Quality Holstein Leasing*, where the court explains that the trustee's strong arm powers:

serve essentially to marshal all of the debtor's assets, including some that the debtor itself could not recover, in order to enhance the resources available to the pool of creditors. Exercise of the powers allows the estate to avoid, among other

D. Competing Property Interests

Bankruptcy cases usually involve many parties competing for limited assets of the debtor. In *General Coffee*, City National Bank attempted to assert its rights via a constructive trust, to acquire assets of the debtor as compensation for the funds that the debtor wrongfully acquired. Simultaneously, the debtor-trustee opposed imposition of the trust because it sought to protect the interests of its general creditors. By invalidating the claims of City National Bank, the debtor-trustee could increase the size of the estate to be shared among the general creditors.²⁹

Bankruptcy law requires a bankruptcy court to apply state law to resolve the rights of competing interests in property.³⁰ For example, in *In re Shepherd*,³¹ the bankruptcy court explained that the court should apply the choice of law rule of the forum state to determine the rights of competing interests in a bankruptcy proceeding. The court determined that Florida law required "a court to apply the law of the state having the most significant relationship to the occurrence and to the parties with respect to the issue."³² The court cited *Bishop v. Florida Speciality Paint Company*³³ for authority. In *Bishop*, the Supreme Court of Florida identified the following factors as the contacts to be considered when choosing the applicable law: a) the place where the injury occurred; b) the place where the conduct causing the injury occurred; c) the domicile, residence, nationality, place of incorporation, and place of business of the parties; and d) the place where the relationship between the parties, if any, was centered.³⁴ The *General Coffee* court presumably applied the above factors in determining that Florida law controlled.³⁵

interests, secret or otherwise unperfected liens on property that the debtor appears to own on the petition date.

752 F.2d 1009, 1014 (5th Cir. 1985).

An important facet of the Bankruptcy Code applicable to the instant case deems the trustee to be without knowledge of any wrongful actions of the debtor, regardless of the trustee's actual knowledge. COLLIER, *supra* note 28, at § 544.01. Therefore, *General Coffee*, as the debtor in possession (trustee), is deemed without knowledge of any fraudulent occurrence.

29. *Id.*

30. See COLLIER, *supra* note 28, at § 544.02.

31. Central Trust Co. v. Shepard (*In re Shepherd*), 29 Bankr. 928 (Bankr. M.D. Fla. 1983).

32. *Id.* at 931.

33. 389 So. 2d 999 (Fla. 1980).

34. *Id.* at 1001. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 145 (1969).

35. *General Coffee Corp.*, 41 Bankr. 781, 783. If Louisiana law had controlled, City Na-

The priority of a judicial lien creditor (for example, a trustee in bankruptcy versus the beneficiary of a constructive trust) must be determined by state law since it involves competing interests in property.³⁶ If the state holds that a constructive trust does not arise until entry of an order declaring the trust to exist, as in Florida, then the trustee in bankruptcy can use the strong arm clause of the Bankruptcy Code to defeat the interests of the constructive trust beneficiary, even though the beneficiary may have a valid claim of fraud against the debtor.³⁷

In *Lancaster v. Key*,³⁸ the beneficiary of a resulting trust took priority over the trustee under section 544(a), since under the applicable state law, a resulting trust arose at the time of the actions creating the trust, and not at the time of judgment. In *Lancaster*, the plaintiffs purchased real property from the debtor in bankruptcy for sixty seven thousand dollars. The transaction was completed on August 17, 1979. The plaintiffs did not record the deed until August 29, 1980, approximately one year later. In the interim, the debtor filed a Chapter Seven petition in bankruptcy. Since under Tennessee state law unregistered deeds are void as to preexisting creditors, the bankruptcy court held that the trustee in bankruptcy, cloaked with his section 544 power, had superior rights to the property.³⁹ The United States District Court for the Eastern District of Tennessee reversed.⁴⁰

In reversing, the court pointed out that a resulting trust arises in Tennessee at the time of the actions creating the trust, not at the time of judgment. Since the actions creating the trust (purchase of the property) occurred prior to the interests of the lien creditor (which arose when the debtor filed for bankruptcy) the plaintiff's rights were superior to the rights of the trustee in bankruptcy.⁴¹

General Coffee required a different resolution. City National

tional Bank would have had no chance of success on the merits. The Louisiana Civil Code prohibits the imposition of a constructive trust or equitable lien on any property. *Mansfield Hardwood Lumber Co. v. Johnson*, 268 F.2d 317, 319 (5th Cir. 1959).

36. In re *Tinnell Traffic Services, Inc.*, 41 Bankr. 1018. *Accord In re Quality Holstein Leasing*, 752 F.2d 1009 (5th Cir. 1985); In re *American International Airways, Inc.*, 44 Bankr. 143 (Bankr. E.D. Pa. 1984).

37. See *supra* notes 20-22 and accompanying text.

38. 24 Bankr. 897 (Bankr. E.D. Tenn. 1982).

39. *Id.* at 899. See also TENN. CODE ANN. § 66-26-103 (1982) (unregistered instrument void as to creditors and bona fide purchasers).

40. 24 Bankr. at 899.

41. *Id.* *Accord In re American Int'l Airways, Inc.*, 44 Bankr. 143 (beneficiary of constructive trust defeated interests of trustee in bankruptcy applying New Jersey state law).

Bank claimed General Coffee's property under a theory of constructive trust, not resulting trust. City National Bank could not become the beneficiary of a constructive trust until a Florida court declared it to be the beneficiary. Meanwhile, General Coffee acquired the rights and powers of a perfect hypothetical judicial lien creditor on the date it filed its petition with the bankruptcy court. Thus, General Coffee's rights necessarily arose prior to those of City National Bank. Since General Coffee's rights were prior, they were held to be superior to the rights of City National Bank.⁴²

42. General Coffee maintained an alternate position for use in the event the trial court did not accept the constructive trust/strong arm clause theory. A constructive trust may only attach to specific property currently in the hands of the defendant. See *Fore Way Express, Inc. v. Mid-American Lines, Inc.* (*In re Mid-American Lines, Inc.*), 24 Bankr. 52, 53 (Bankr. W.D. Mo. 1982).

The Restatement of Restitution provides: "[W]here a person wrongfully disposes of the property of another but the property cannot be traced into any product, the other has merely a personal claim against the wrongdoer and cannot enforce a constructive trust or lien upon any part of the wrongdoer's property." RESTATEMENT OF RESTITUTION § 215(1) (1936).

Comment A to the Restatement section states:

Where a person wrongfully disposes of the property of another, the other is not entitled to priority over the general creditors of the wrongdoer merely because of the character of the wrong done to him. Thus, if a trustee sells trust property and dissipates the proceeds, the beneficiary of the trust is not entitled to priority over other claimants of the trustee (see Restatement of Trusts, § 202). The claimant must prove not only that the wrongdoer once had property legally or equitably belonging to him, *but that he still holds the property* or property which is in whole or in part its product. (Emphasis added).

Id.

Comment a.

It is clear that this strict tracing requirement is the law in Florida. See *Schifter v. First Fidelity Fin. Serv., Inc.* (*In re First Fidelity Fin. Serv., Inc.*), 36 Bankr. 508, 512 (Bankr. S.D. Fla. 1983) ("the rule repeatedly expressed in the Florida cases is that trust funds must be strictly traceable to particular property which is capable of clear identification."). The facts in the instant case showed that the purchase price of Chase & Sanborn consisted of three million dollars cash, a note in the amount of four and three quarters million dollars, and the value of certain inventory determined on the day before closing. The evidence at trial showed the value of the inventory to be \$6,488,011. Additionally, the evidence at trial demonstrated that the funds went directly to purchase the inventory, that the inventory was later dissipated, and that the proceeds therefrom were comingled with other funds. 41 Bankr. at 782.

It was the defendant's position that since these funds no longer existed as an identifiable entity, there was no res over which a constructive trust could attach. See The Trial Memorandum for General Coffee at 10, *General Coffee Corp.* 41 Bankr. 781. City National Bank, on the other hand, asserted that since the funds were directly traceable to the purchase of Chase & Sanborn, they were entitled to a constructive trust over the assets of Chase & Sanborn. Trial Brief for Plaintiff at 7-8, *General Coffee Corp.*, 41 Bankr. 781. The question was, how far did the tracing requirement go? City National Bank argued that since they traced the funds to the contract for the purchase of Chase & Sanborn, they were entitled to a constructive trust over *all* of the assets of that company. *Id.* General Coffee, con-

IV. INTERPLAY BETWEEN §§ 544 AND 541

City National Bank took the position that section 541 of the Bankruptcy Code⁴³ "removes" the subject matter of the instant

versely, asserted that City National Bank could not conveniently stop tracing at will, but had to continue to trace as far as possible. Trial Memorandum for General Coffee at 10, *General Coffee Corp.*, 41 Bankr. 781. The funds were directly traceable to inventory which had since been dissipated. Accordingly, General Coffee insisted, there was no trust res over which a constructive trust could attach.

Judge Britton, without discussing the issues involved, stated in one sentence, "I find that the trust res in the amount of \$6,488,011.00 has been traced by the plaintiffs in its original or substituted form to assets presently within the control of the debtor." *General Coffee Corp.*, 41 Bankr. at 783. General Coffee is likely to allege that Judge Britton erred in this finding when it argues the appeal.

43. 11 U.S.C. § 541 (1982). Section 541 reads:

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

(2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is—

(A) under the sole, equal, or joint management and control of the debtor; or

(B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.

(3) Any interest in property that the trustee recovers under section 543, 550, 553, or 723 of this title.

(4) Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510(c) or 551 of this title.

(5) An interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date—

(A) by bequest, devise, or inheritance;

(B) as a result of a property settlement agreement with the debtor's spouse, or of an interlocutory or final divorce decree; or

(C) as a beneficiary of a life insurance policy or of a death benefit plan.

(6) Proceeds, product, offspring, rents, and profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.

(7) Any interest in property that the estate acquires after the commencement of the case.

(b) Property of the estate does not include any power that the debtor may only exercise solely for the benefit of an entity other than the debtor.

(c)(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision—

controversy from the "property of the estate."⁴⁴ Because the property is not part of the estate, the powers of the trustee in bankruptcy under the strong arm clause are to no avail; those powers apply only to "property of the debtor,"⁴⁵ and not to property excluded from the debtor's estate by the operation of section 541. The crux of this argument is that property wrongfully obtained is not part of the estate no matter when the constructive trust over the property arises.

City National Bank may find support for its argument in the decision of *In re Fieldcrest Homes, Inc.*⁴⁶ In *Fieldcrest*, according to the complaint, Independence Land Title Company of Illinois (Independence), a corporation related to Fieldcrest Homes, Inc.

(A) that restricts or conditions transfer of such interest by the debtor; or

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or the taking possession by a trustee in a case under this title or a custodian, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

(2) A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.

(d) 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) 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.

(e) The estate shall have the benefit of any defense available to the debtor as against an entity other than the estate, including statutes of limitation, statutes of frauds, usury, and other personal defenses. A waiver of any such defense by the debtor after the commencement of the case does not bind the estate.

44. Section 541 of the Bankruptcy Code defines "property of the estate." The legislative history of that section makes it clear that in defining "property of the estate," Congress did not intend "to expand the debtor's rights against others more than they exist[ed] at the commencement of the case." H.R. REP. No. 595, 95th Cong., 1st Sess. 367-68 (1977) reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5868; S.REP. No. 989, 95th Cong., 2d Sess. 82-83 (1978), reprinted in 1978 U.S. CODE & AD. NEWS 5787, 6323.

In other words, an interest in property that is limited in the hands of the debtor is equally limited in the hands of the estate's trustee in bankruptcy. Based on these statements of the purpose of section 541, City National Bank argues that if the debtor, General Coffee, was not entitled to retain the assets prior to bankruptcy because it had obtained them fraudulently, then the trustee in bankruptcy similarly may not retain the assets irrespective of when a constructive trust over the assets arises. The Trial Brief for Plaintiff, *General Coffee Corp.*, 41 Bankr. 781.

45. See 11 U.S.C. § 544(a).

46. 18 Bankr. 678 (Bankr. N.D. Ill. 1982).

(Fieldcrest), collected escrow money from home buyers but failed to use the money to pay off construction mortgagees as the parties had agreed. U.S. Life, underwriter of the title insurance policies, had to pay three hundred thousand dollars for claims made upon the policies.⁴⁷ U.S. Life contended that since Independence diverted the escrow funds to Fieldcrest, the bankruptcy court should place a constructive trust upon three hundred thousand dollars of Fieldcrest's assets. The trustee in bankruptcy filed a motion to dismiss. The bankruptcy court denied the motion holding that it was proper to impose a constructive trust upon assets in the estate, notwithstanding the trustee's status as a bona fide purchaser under section 544 of the Bankruptcy Code.⁴⁸

Fieldcrest is not dispositive in the instant controversy. The *Fieldcrest* court reached the correct conclusion, but for the wrong reason. The Illinois court never addressed the dispositive issue of when a constructive trust arises in Illinois. Had it done so, it would have discovered that a constructive trust arises at the time of the wrongful act.⁴⁹ In *Fieldcrest*, the wrongful act transpired prior to the filing of the petition for bankruptcy reorganization. Therefore, applying Illinois state law, section 541 operated to remove the property from the estate, enabling the beneficiary of the constructive trust to defeat the trustee in bankruptcy.

It is clear, at least to the Fifth Circuit Court of Appeals, that "[w]here state law impresses property that a debtor holds with a constructive trust in favor of another, and *the trust attaches prior to the petition date*, the trust beneficiary normally may recover its equitable interest in the property through bankruptcy court proceedings."⁵⁰ Accordingly, the decision in *Fieldcrest* was correct. The Fifth Circuit Court of Appeals, however, made it equally clear that "section 541(d) overcomes the trustee's section 544 powers *only where state law confers equitable title on a third party effective prior to the commencement of the bankruptcy case.*"⁵¹

Under Florida law, a constructive trust arises when a court declares one to exist, and not prior to such a declaration. Therefore, the property over which City National Bank sought to impose a constructive trust will remain property of the estate. Since the

47. *Id.* at 679.

48. *Id.*

49. *Hagerty v. General Motors Corp. (In re Quality Holstein Leasing)*, 14 Ill. App. 3d 33, 43, 302 N.E.2d 678, 686 (1973) (supplemental opinion).

50. *Vineyard v. McKenzie*, 752 F.2d 1009, 1014 (5th Cir. 1985)(emphasis added).

51. *Id.* at n.10 (emphasis added).

bankruptcy court did not declare that a constructive trust existed prior to General Coffee's filing a petition for reorganization,⁵² and the property remained property of the estate,⁵³ the strong arm clause empowered the trustee to retain the assets against the beneficiary of the constructive trust, City National Bank.⁵⁴

52. See *supra* text accompanying notes 4-7.

53. For example, in *In re Tinnell Traffic Services*, a trustee sought to set aside a transfer from the debtor to the defendant as preferential. 41 Bankr. 1018. The defendant alleged the property had been fraudulently obtained from them, and therefore, the debtor merely held the property as a constructive trustee for the benefit of the defendant. The court noted that since a debtor can only transfer property that is property of the estate, resolution of this issue is a threshold requirement in addressing the trustee's preferential transfer claim. Applying Tennessee state law which, like Florida law, deems a constructive trust to arise only when a court declares one to exist. The court reasoned:

[s]ince constructive trusts are judge-created equitable remedies, the trust does not come into existence until imposed by a court of equity. (Citations omitted). In this case, it is clear that a constructive trust did not exist at the time the debtor transferred the funds to the defendant. Without a judicial decree imposing a constructive trust on the property in question, this court must hold that the property transferred from the debtor to the defendant was indeed property of the debtor.

Id. at 1021. Accordingly, the court determined that the property remained property of the debtor, and subject to the trustee's preferential transfer claim.

54. In addition to the *Fielcrest* court's failure to address an essential issue, the case can be invalidated on other grounds. Its holding seems to be in conflict with both *Noyes v. Phillips* (*In re Phillips*), 21 Bankr. 565 (Bankr. D. Conn. 1982), and *Loup v. Great Plains Western Ranch Co.* (*In re Great Plains Western Ranch Co.*), 38 Bankr. 899 (Bankr. C.D. Cal. 1984), which Judge Britton expressly adopted in the *General Coffee* opinion. *General Coffee*, 41 Bankr. at 784.

Great Plains held that a trustee in bankruptcy, due to his status as a bona fide purchaser under section 544(a)(3), defeated the beneficiary of a constructive trust, even though the constructive trust arose prior to the filing of the bankruptcy petition. 38 Bankr. at 906. The court stated that even if section 541 removed the property from the estate, section 544(a)(3) brought it back in. *Id.*

In *In re Phillips*, the plaintiff sought to impose a constructive trust upon funds owed by the debtor under a promissory note and mortgage deed. The plaintiff conceded that legal title to the mortgage was in the debtor but insisted that the equitable interest to the mortgage was with the plaintiff. 21 Bankr. at 566-67.

The court held that the debtor's position as a bona fide purchaser defeated the plaintiff's claim as a beneficiary of a constructive trust. It stated:

Where a person acquires title to property under such circumstances that otherwise he would hold it upon a constructive trust or subject to an equitable lien, he does not so hold it if he gives value for the property without notice of such circumstances. As a bona fide purchaser, . . . the trustee's interest in the property for the benefit of the estate is prior to whatever interest the plaintiff may have. (Citations omitted).

Id. at 568.

Without expressly referencing the case, Shawmut Boston International Banking Corporation (Shawmut), as intervenor, sought to extend the holding of *In re Phillips*. It took the position that to the extent the controversy involved real property, General Coffee's interest pursuant to the strong arm clause defeated those of City National Bank regardless of when the constructive trust arose. Memorandum of Law In Support of Shawmut Boston Interna-

V. THE APPEAL

City National Bank has filed a Notice of Appeal.⁵⁵ Predictably, its position in the United States District Court for the Southern District of Florida will be similar to its position in the bankruptcy court. If this argument fails, as it did in the bankruptcy court, City National Bank should consider an appeal to the Eleventh Circuit Court of Appeals. The Eleventh Circuit must apply Florida law.⁵⁶ Under Florida Rule of Appellate Procedure 9.030, the Supreme Court of Florida has discretionary jurisdiction over questions of law certified by a United States Court of Appeals that are 1) determinative of the cause of action and 2) for which there is no controlling precedent of the Supreme Court of Florida.⁵⁷ City National Bank should be able to satisfy the requirements of Rule 9.030 because there is no controlling precedent of the Supreme Court of Florida on the issue of *when* a constructive trust arises, and the issue is determinative of the instant controversy. Only one Florida case, *Palmland Villas I Condominium Association v. Taylor*,⁵⁸ a decision of the Florida Fourth District Court of Appeal, has reached the issue of when a constructive trust arises.

If City National Bank convinces the Supreme Court of Florida

tional Banking Corporation's Motion For Judgment on Pleadings, at 8, *General Coffee Corp.*, 41 Bankr. 781. This contention is without merit. In *In re Phillips*, under the applicable state law, a bona fide purchaser of real property defeated the beneficiary of a constructive trust *irrespective* of when the constructive trust arose. 21 Bankr. at 568. Therefore, the property remained property of the estate and subject to the strong arm clause powers. In the instant case, however, if the court had determined that a constructive trust predated the bankruptcy petition, the property would have been removed from the property of the estate, and not subject to the trustee's strong arm clause powers.

55. The parties had originally stipulated to appeal the case directly to the Eleventh Circuit Court of Appeals pursuant to 28 U.S.C. § 1293(b) (1982). In *In re General Coffee Corp.*, however, the court determined that Congress had repealed § 1293(b), abolishing the jurisdiction of the courts of appeals to hear direct appeals from the bankruptcy courts, No. 84-5737 (11th Cir. Apr. 3, 1985). Although lacking jurisdiction to hear the appeal, the court exercised its transfer authority under 28 U.S.C. § 1631 (1982), and transferred the appeal to the United States District Court for the Southern District of Florida. *Id.*

56. See *supra* text accompanying notes 30-36.

57. The applicable parts of Rule of Appellate Procedure 9.030 provide:

(2) Discretionary Jurisdiction. The discretionary jurisdiction of the Supreme Court may be sought to review: . . .

. . . .
 . . . (C) questions of law certified by the Supreme Court of the United States or a United States Court of Appeals that are determinative of the cause of action and for which there is no controlling precedent of the Supreme Court of Florida.

FLA. R. APP. P. 9.030(a)(2) (1985).

58. 390 So. 2d at 123. See *supra* notes 20-22 and accompanying text.

to certify the question, it has only crossed the first hurdle. It must also convince the court to accept jurisdiction to rule upon the issue. Since the court's jurisdiction is discretionary, City National Bank cannot compel the court to address the certified question. To persuade the Supreme Court of Florida to accept jurisdiction, City National Bank can argue that a single case bars its right to recovery, and that it is entitled to have the Supreme Court of Florida decide whether the law stated in *Palmland* is a correct statement of Florida law. Arguments against the court exercising its jurisdiction are that the language in *Palmland* is clear and unambiguous, and that a second court, the Fifth District Court of Appeal, cited *Palmland* as controlling precedent.⁵⁹

If City National Bank can point to a decision in conflict with *Palmland*, it will enhance its chances of convincing the Supreme Court of Florida to accept jurisdiction. It may try to argue that the Florida Second District Court of Appeal decision in *Blumin v. Ellis*⁶⁰ is in conflict with *Palmland*, but that argument should fail. In *Blumin*, the court considered the question of when an equitable lien arises. Equitable liens, however, are distinguishable from constructive trusts, and more closely resemble resulting trusts since they arise out of thwarted intentions. In *Blumin*, the court imposed an equitable lien by virtue of an intention demonstrated in a written contract.⁶¹ The court held, "[a]lthough we have found no reported decisions in this state on this question, nor any from our sister state courts that are squarely on point, we hold that equitable liens arise at the time of the transaction from which they spring."⁶² Thus, equitable liens, created pursuant to the intentions of the parties, arise at the time of the agreement, not at the time the court declares that they exist.

If equitable liens were analogous to constructive trusts, one might argue that *Blumin* represents a contradictory decision to *Palmland*. *Blumin*, however, is clearly distinguishable from *Palmland*. *Blumin* deals with a lien chargeable to a written document expressing the intentions of the parties. A constructive trust, however, is a complete fiction; a remedy designed to do equity without regard to the intentions of the parties.⁶³ Accordingly, the creation of a constructive trust must await the decision of an equity court

59. See *supra* note 22.

60. 186 So. 2d 286 (Fla. 2d DCA 1966).

61. *Id.* at 294.

62. *Id.* at 295.

63. See *supra* notes 10-14 and accompanying text.

while the equitable lien arises at the time of the transaction, merely awaiting a court decision for its perfection. Thus, it appears that the various districts in Florida are not in conflict on this issue.

VI. CITY NATIONAL BANK V. GENERAL COFFEE: A GOOD DECISION?

After a cursory reading of *General Coffee*, one's initial inclination is to recognize that money was stolen from City National Bank, and to feel the money should be returned. The equities involved, however, are not so simplistic. While it is true that General Coffee fraudulently obtained the funds from City National Bank, funds were also fraudulently obtained from several other creditors. For example, false financial documents were used by General Coffee's officers to obtain a loan from Shawmut International Bank. By defending this action, General Coffee is protecting the rights of *all* of its creditors,⁶⁴ some of which deserve the funds as much or more than City National Bank. Through various fraudulent measures, the debtor allegedly obtained in excess of fifty million dollars from banks. All of the banks are now unsecured creditors seeking to salvage a minute percentage of the money owed to them that was forfeited. The cost of any award to City National Bank will be borne directly by these creditors, not General Coffee, the fraudfeasor. A United States Bankruptcy Court in Florida recognized this situation and stated, "a consideration of the equities to all parties concerned is involved; the court may not focus solely on the equities from the standpoint of the person wronged."⁶⁵ In Professor Scott's words, "[T]o be liberal is not always to be just, particularly where someone other than the liberal minded person foots the bill."⁶⁶ There is no doubt in this author's mind that Judge Britton, when faced with the facts and law before him in *General Coffee*, correctly decided the matter. Although the ruling is unique, the situation was envisioned by legal scholars before the case arose. The American Law Institute, in its tentative draft number two of the Restatement of Restitution, Second, recognized the situation but conspicuously chose to avoid it:

In controversies over the distribution of a debtor's assets, a constructive trust or equitable lien is prior in right to the claims of his general creditors. If the debtor has acquired property by

64. See *supra* note 28.

65. Schifter v. First Fidelity Services, Inc. (*In re* First Fidelity Fin. Serv., Inc.), 36 Bankr. 508, 511 (Bankr. S.D. Fla. 1983).

66. See Scott, *supra* note 11, at § 521.

fraud, and the person defrauded can identify that property—or its proceeds—as an asset of the debtor, the value of that asset will be applied in satisfaction of the duty before it is used to satisfy ordinary debts of the wrongdoer.⁶⁷

The above language seems to support the position asserted by City National Bank. The comment, however, continues:

The general rule of precedence just stated is subject to a number of qualifications. It is modified by certain provisions of the Bankruptcy Code [11 U.S.C.] in favor of the bankruptcy trustee as a representative of creditors. (See, for example, section 544(a)(3).) . . . *It is not within the scope of this Restatement to describe statutory provisions whereby restitutionary rights are limited or extended in particular circumstances.*⁶⁸

The American Law Institute recognized the issue that is the subject of the instant case, but chose not to address it, leaving the decision instead to the courts.

VII. CONCLUSION

City National Bank v. General Coffee has already been designated as controlling in a subsequent Florida bankruptcy proceeding, albeit in front of the *General Coffee* judge.⁶⁹ Clearly, *General Coffee*, if affirmed on appeal, will have drastic effects upon the practice of bankruptcy law in Florida. Constructive trusts, utilized in equity to rectify fraud, will no longer be appropriate tools in a bankruptcy court. The result is justified because when a wrongdoer files for bankruptcy, the case no longer affects just the fraudfeasor and victim. It also affects other creditors competing for limited assets of the debtor. Any generosity shown to a party seeking the imposition of a constructive trust necessarily diminishes the estate to be divided among the remaining creditors. Although it is easy to sympathize with City National Bank, this is one of the many areas in law in which it is impossible to please everyone.

ANDREW P. GOLD*

67. RESTATEMENT (SECOND) OF RESTITUTION § 43 comment b (Tent. Draft No. 2, 1984).

68. *Id.* (emphasis added).

69. *In re Guaranteed Ins. Underwriters, Inc.*, 44 Bankr. 1004 (Bankr. S.D. Fla. 1984). Additionally, counsel relied upon *General Coffee* in *Series 1 v. J. Janis (In re J. Janis: A.L. Orchards Ltd.)*, 45 Bankr. 295 (Bankr. S.D. Fla. 1985), although the court determined the point was moot.

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