

Affirmative defenses
Equitable Liens
Equitable Subrogation
Resulting Trust

Paul Lansdowne, Inc., v Marko et al, Adversary No. 687-5025
(In re Cox), Consolidated Case Nos 684-08459, 08496-98

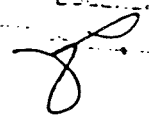
2/2/93 D. Ct. (J. Hogan) aff'd in part, rev'd in part
and unpublished
Remanded decision by PSH

District court affirmed in part, reversed in part and remanded for adjustment of judgment originally awarding \$118,291.55 to trustee as value of real property in turnover action under § 542, after offsets and improvements. By memorandum opinion dated 2/5/91 (E91-3((97))), Judge Higdon had determined that good faith improvers of rental property, who had purchased the property from parties who had acquired ownership via a forged quitclaim deed from debtors, were not entitled to imposition of a resulting trust in favor of the forger to 50% of the property. The District Court reversed, holding that because the bankruptcy court determined the forger put up half the purchase money with the debtor, he was entitled to a resulting trust by operation of state law (Calif.) And his half never became estate property. The District Court also held that no standing issue arose, and that the bankruptcy court's characterizing the resulting trust as an affirmative defense was unwarranted because "[i]n the context of this case, it is more accurately characterized as a matter of denial than of avoidance or affirmative defense." District Court further reversed an offset of \$27,5000 "equitable lien" to defendants, representing increased value attributable to improvements, holding that this equitable remedy is not available when, as here, the good faith improvers' sole remedies were statutory under state law, albeit not applicable under the facts. The District Court affirmed the bankruptcy court's allowance, under principals of equitable subrogation, of offsets for encumbrances satisfied by defendants, and affirmed in all other respects.

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EUGENE, OREGON



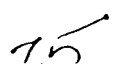
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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF OREGON

In re)	CV-92-6132-HO
)	
S.D. COX INVESTMENTS, INC.,	)	Bankruptcy Court
STEVEN D. COX, DEBORAH M. COX, and)	Case Nos. 684-08450-H7
EUGENE R. RICHMOND JR.,)	684-08496-H7
)	684-08497-H7
Debtors.)	684-08498-H7
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PAUL LANSDOWNE, INC., Trustee,)	Adversary Proceeding No.
)	687-5025-H
Plaintiff-Appellant,)	
vs.	)	OPINION
TAMARA MARKO, et al.,)	
Defendant-Appellees.)	

Keith Y. Boyd
 Boyd & Wade
 921 Country Club, No. 100
 Eugene, Oregon 97401
 Attorney for Plaintiff-Appellant

Richard Baroway
 Eric Lindenauer
 Garvey, Schubert & Barer
 121 S.W. Morrison Street, Eleventh Floor
 Portland, Oregon 97204
 Attorneys for Defendants
 Ray W. Erta and Linda S. Erta



1 HOGAN, Judge:

2 This bankruptcy matter involves conflicting claims to a
3 parcel of real property. Record title to the property was once
4 held by Steven Cox, a debtor in the underlying bankruptcies.
5 The trustee, Paul Lansdowne, Inc. (plaintiff), brought an
6 action for turnover of the property against, among others,
7 defendants Ray and Linda Erta, its current record owners.
8 After a trial, the bankruptcy court ruled for plaintiff,
9 ordering the Ertas to pay a money judgment of approximately
10 \$118,000, reflecting the value of the property less setoffs.
11 Both parties now appeal from certain of the bankruptcy court's
12 rulings. For the reasons which follow, I affirm in part,
13 reverse in part, and remand for adjustment of the judgment in
14 accord with this opinion.

15 BACKGROUND

16 The property at issue is located at 416 Riverside Drive,
17 Watsonville, California. It consists of three rental units on
18 approximately 3/4 acres of land. Record title vested in the
19 debtor Steven D. Cox with the recording, on February 28, 1983,
20 of a grant deed from Barry J. Nottoli. Cox was then an
21 investment broker and businessman in Medford, Oregon.

22 Nottoli had become the record owner of the property just
23 seven weeks before the transfer to Cox, through a grant deed
24 from Mary Tomasello recorded on January 6, 1983. At the time
25 the Nottoli-to-Cox deed was recorded, the property was
26 encumbered by two previously recorded deeds of trust: one from

1 Notolli to Tomasello for \$87,500.00, and one from Notolli to
2 NCI, Inc. for \$2,000.00.

3 Cox managed the Watsonville property through Cox Property
4 Management, a business he ran to manage his several real estate
5 holdings. On September 24, 1984, however, Cox and his wife
6 fled the Medford area as fugitives from justice, abandoning
7 their businesses, which were then on the verge of collapse and
8 under investigation by law enforcement agencies for securities
9 violations. The Coxes' creditors successfully petitioned to
10 have them declared involuntarily bankrupt. Cox remained hidden
11 until December, 1988 when he was apprehended by the F.B.I. He
12 later pled guilty to racketeering charges.

13 Promptly after the Coxes fled, James Cardinal, a Cox
14 associate, began collecting rent from the Watsonville tenants.
15 On October 3, 1984, Cardinal appeared before a California
16 notary public with a quitclaim deed by which he claimed Steven
17 and Deborah Cox had conveyed their interest in the Watsonville
18 property to Tamara Marko, Cardinal's girlfriend. Cardinal
19 declared before the notary that he had witnessed the Coxes
20 execute and deliver the quitclaim deed on March 16, 1984. The
21 notary notarized Cardinal's declaration and his acknowledgement
22 of his own signature as witness. Cardinal had the deed
23 recorded in the Santa Cruz County, California Recorder's
24 Office.

25 Cardinal then listed the property for sale. He forged
26 Marko's name to a listing contract with William A. Bergstrom,

1 Inc., a realtor, on October 31, 1984. A year later, on
2 November 4, 1985, Ray Erta contracted to purchase the property
3 for \$150,000.00. At closing, Marko, paid from the purchase
4 price a total of \$99,208.45 to satisfy the two trust deeds and
5 outstanding property taxes.

6 Ray and Linda Erta took possession on January 1, 1986.
7 In March, 1987, the plaintiff trustee filed this adversary
8 proceeding, naming the Ertas as defendants and claiming title
9 to the property on behalf of the bankruptcy estates. Plaintiff
10 sought to avoid the transfer of title to the Ertas on several
11 theories, principally that the quitclaim deed to Marko was
12 forged and thus void. The Ertas refused to surrender title and
13 filed an answer asserting several defenses.

14 The case was tried before the bankruptcy court in
15 Medford, Oregon between July 24 and August 4, 1989. A further
16 evidentiary hearing was held on January 24, 1991 regarding the
17 property's value. The bankruptcy court issued findings of fact
18 and conclusions of law on February 5, 1991 (cited herein as
19 Findings), and entered judgment for plaintiff on March 8, 1991.
20 The court found that the Cox-to-Marko quitclaim deed had been
21 forged, and that the subsequent transfer to the Ertas was void.
22 The court directed the Ertas to pay plaintiff a money judgment
23 for \$118,291.55, representing the value of the property as of
24 February 5, 1991 (\$245,000.00), plus net rents received by the
25 Ertas (\$0), less a credit setoff for payment of encumbrances
26 and property taxes (\$99,208.45), and less a further "equitable

1 lien"/credit setoff for the increase in value to the property
2 which the court found had resulted from the Erta's good faith
3 improvements (\$27,500.00).

4 Both parties appeal. The Ertas contend the bankruptcy
5 court erred in rejecting their contention that the bankruptcy
6 estate held title to 50% of the property subject to a resulting
7 trust for the benefit of Cardinal. They contend such a trust
8 should be recognized and the judgment reduced accordingly. The
9 trustee alleges the bankruptcy court erred in allowing the
10 increased value and encumbrance setoffs.

11 STANDARD OF REVIEW

12 "The district court acts as an appellate court, reviewing
13 the bankruptcy court's findings of fact under the clearly
14 erroneous standard and its conclusions of law de novo." In re
15 Daniels-Head & Associates, 819 F.2d 914, 918 (9th Cir. 1987).

16 DISCUSSION

17 1. The Resulting Trust Contention

18 The bankruptcy court found that when Cox purchased the
19 property from Nottoli, Cardinal contributed 50% of the down
20 payment. Only Notolli, Cardinal, and Cox had been directly
21 involved in the transfer. Each testified that Cardinal was to
22 hold an equitable interest in the property. They differed,
23 however, as to the extent of Cardinal's equitable interest.
24 Notolli and Cardinal testified that the entire interest was to
25 be held by Cox for Cardinal, while Cox testified that Cardinal
26 was to own only a 50% interest.

1 The Ertas argue that because Cardinal contributed 50% of
2 the down payment, and because Cox had himself intended that
3 Cardinal owned half of the property, a purchase money resulting
4 trust benefiting Cardinal arose by operation of law over half
5 of the property. Consequently, they contend, the bankruptcy
6 court erred as a matter of law in awarding plaintiff the entire
7 equitable interest.

8 a. Relevant Procedural History

9 The Ertas first asserted their resulting trust defense in
10 an amended answer filed on June 30, 1988. Plaintiff argued
11 that the Ertas lacked standing to assert this defense, and the
12 parties briefed that question to the bankruptcy court. To
13 strengthen their position, the Ertas also moved for relief from
14 the automatic stay to record a quitclaim deed from Cardinal (by
15 which he purported to surrender to them all of his interest in
16 the property). The bankruptcy court initially ruled for the
17 defendants on the standing question, by a letter to counsel
18 dated May 19, 1989. The court there noted that if the evidence
19 at trial were to conflict as to

20 Cox's ownership of the property before the
21 purported transfer to Tamara Marko . . . [the
22 court] will necessarily have to consider the
23 various rights of the parties in the property,
24 whether or not the [resulting trust defense] is
25 raised . . . and [will] have discretionary power to
26 impose an equitable trust if warranted under the
27 facts Therefore, the issue of standing is
28 moot and you may prepare for trial accordingly.

29 Supplemental Excerpt of Record, at 3 (emphasis added).

30 / / /

1 In its initial post-trial Findings, the bankruptcy court
2 reversed itself, ruling that defendants lacked standing to
3 assert the resulting trust defense, because in doing so they
4 rested on the legal rights of another (Cardinal). Findings at
5 58-59. The court also found that Cardinal had waived the
6 resulting trust defense, which it considered an affirmative
7 defense, by failing to plead it. Id. at 59. Even if the court
8 could impose a trust on Cardinal's behalf, the court stated, it
9 would decline to do so because his "conduct does not warrant
10 such extraordinary equitable relief." Id. at 60.

11 The Ertas moved for amendment of the court's findings
12 based on the court's failure to address the effect of the
13 quitclaim deed from Cardinal to them. The court had never
14 ruled on the Ertas' earlier motion for relief from the
15 automatic stay to record that deed. The Ertas' post-trial
16 motion to amend findings was denied from the bench on April 11,
17 1991. Excerpt of Record, X.¹ The court reasoned that the
18 Ertas lacked standing to raise the resulting trust; that even
19 if standing existed, the Ertas' position was no better than
20 Cardinal's and the court would not, in the exercise of its
21 discretion, impose a trust in favor of Cardinal due to his
22 character and his methods of dealing with Steven Cox; that
23 Cardinal had waived any right to assert a resulting trust by
24 failing to plead it; and that the quitclaim deed from Cardinal

25
26 ¹ The Excerpt of Record will be hereafter be cited as "Exc."

1 to the Ertas had itself violated the automatic stay, and was
2 thus void or voidable. Id. pp. 9-17.

3 Defendants now contend (1) that the court erred in
4 concluding they lacked standing to assert the resulting trust
5 defense, and (2) that the court improperly considered
6 Cardinal's worthiness of equitable relief, because a resulting
7 trust arose by operation of law based on the fact of Cardinal's
8 contribution to the purchase price of the property and the
9 parties' intent that he take an equitable interest in it.

10 b. Standing

11 (1) Background

12 The bankruptcy court awarded plaintiff's judgment based
13 on 11 U.S.C. § 542. Under § 542(a), the bankruptcy trustee is
14 entitled to turnover of property that the trustee "may use,
15 sell or lease under [11 U.S.C.] section 363." Section 363(b)
16 entitles the trustee to use, sell or lease "property of the
17 estate."² In seeking turnover, it is the trustee's burden
18 initially to prove that the property in issue is "property of
19 the estate." Yaquinto v. Greer, 81 Bankr. 870, 878 (Bankr.
20 N.D. Tx. 1988).

21 Section 541 defines property of the estate. Under §
22 541(d), where the debtor possesses only a legal and not an
23 equitable interest in property, the equitable interest does not
24

25 ²Subsections f, g, and h of section 363 permit the trustee,
26 under special circumstances, to sell more than the property of the
estate. However, none of those circumstances obtains here.

1 become a part of the estate. Matter of Torrez, 63 Bankr. 751,
2 753 (9th Cir. BAP 1986), aff'd, 827 F.2d 1299 (9th Cir. 1987);
3 In re Gurs, 34 Bankr. 755, 757 (9th Cir. BAP 1983). The
4 Supreme Court has stated that "[c]ongress plainly excluded
5 [from the bankruptcy estate] property of others held by the
6 debtor in trust at the time of the filing of the petition."
7 United States v. Whiting Pools, Inc., 462 U.S. 198, 205 n.10
8 (1982).

9 The existence or nonexistence of a trust is determined by
10 state law. Torrez, 63 Bankr. at 754. California law governs
11 that question here, because California is the situs of the
12 property at issue. Id.

13 (2) Was Standing At Issue?

14 The Ertas contend that under the facts as found by the
15 bankruptcy court, a resulting trust in favor of Cardinal arose
16 by operation of California law. Consequently, they contend,
17 the estate lacked an equitable interest in the property -- and
18 thus ownership -- beyond the extent of the 50% interest
19 previously held by Cox for his own benefit. The Ertas argue
20 that this lack of ownership on the estate's part is a missing
21 element of the plaintiff's claim, rather than an affirmative
22 defense upon which they bear the burden of proof. On this
23 basis, they contend the resulting trust defense does not
24 present a question of standing, because they were entitled to
25 defend against plaintiff's claim regardless of standing.

26 / / /

1 Plaintiff counters that under California law, a party
2 seeking to enforce a resulting trust against the record title
3 owner must plead and prove his entitlement to such a trust. In
4 support, plaintiff cites Calistoga Civic Club v. City of
5 Calistoga, 143 Cal. App. 3d 111, 191 Cal. Rptr. 571, 577
6 (1983). To defend against the estate's turnover claim,
7 however, the Ertas need not necessarily prove their own
8 entitlement to a trust, but rather merely that under state law,
9 a trust existed, and thus that the estate did not own the
10 property held in trust. It follows that to effectively rebut
11 the Ertas' argument that no standing question arises, plaintiff
12 must show that a resulting trust does not exist until enforced
13 by its beneficiary. The Calistoga case does not support this
14 proposition. The court stated there that

15 A resulting trust is often called an 'intention
16 enforcing' trust. It arises by implication of law
17 ([citing former Cal. Civil Code] § 853)[fn] to
enforce the inferred intent of the parties to a
transaction.

18 191 Cal.Rptr. at 577 (emphasis added). In the footnote
19 appended to this passage, the court noted

20 [Former Cal. Civil Code] Section 853 provides that:
21 'When a transfer of real property is made to one
22 person, and the consideration therefor is paid by
23 or for another, a trust is presumed to result in
favor of the person by or for whom such payment is
made.'

24 Id. (quoting former Cal. Civil Code § 853, repealed, ch. 820,
25 §§ 5, 43 1986 Cal. Stat. 439, 505) (emphasis in original). The
26 Ninth Circuit has noted that the repeal of § 853 did not

1 disturb the California caselaw concerning trusts. In Re
2 Torrez, 827 F.2d 1299, 1300 n.2 (9th Cir. 1987).

3 The bankruptcy court's opinion did not expressly respond
4 to the Ertas' argument that no standing issue arose from the
5 trust defense. Findings at 56-59. Rather, the bankruptcy
6 court seems to have inferred that standing was at issue from
7 its conclusion that the trust defense is an affirmative defense
8 under Federal Rule 8(c). See id. at 59. As noted, the Ertas
9 dispute the court's characterization of the trust defense as an
10 affirmative defense. The only authority cited in support of
11 that characterization is 5 Wright & Miller, FEDERAL PRACTICE
12 AND PROCEDURE § 1270, at 411 (1990). That citation, however,
13 constitutes no more than a restatement of the conclusion. The
14 cited text only introduces the subject of affirmative defenses,
15 without stating that any specific defense constitutes one.
16 Moreover, neither the bankruptcy court nor plaintiff has cited
17 authority for the proposition that assertion of an affirmative
18 defense invariably raises a question of standing.

19 (3) Conclusion

20 I conclude that no standing issue arose. Characterizing
21 the resulting trust as an affirmative defense was unwarranted.
22 In the context of this case, it is more accurately
23 characterized as a matter of denial than of avoidance or
24 affirmative defense. See Fed. R. Civ. P. 8(b), (c). The
25 trustee in a turnover action has the burden of establishing
26 that the property at issue is property of the estate.

1 Yaquinto, 81 Bankr. at 878. Property of others held by the
2 debtor in trust when a bankruptcy petition is filed is not
3 property of the estate. Whiting Pools, 462 U.S. at 205 n.10.
4 The estate's claim to ownership of the property in this case is
5 based solely on the Nottoli-to-Cox transfer. If a resulting
6 trust over 50% of the property arose by operation of California
7 law from the circumstances of that transfer as found by the
8 bankruptcy court, that portion of the property was not property
9 of the estate. To that extent, the trustee would have failed
10 to establish an element of its claim on which it bore the
11 burden of proof, and would not be entitled to judgment.

12 c. Did a Trust Arise?

13 Under California law, when one party pays the purchase
14 price for real property and places it in another's name, a
15 resulting trust is presumed to arise. In re Torrez, 827 F.2d
16 at 1300, n.2. Partial or pro tanto resulting trusts are also
17 recognized. Martin v. Kehl, 145 Cal. App. 3d 228, 193 Cal.
18 Rptr. 312, 318 (1983).

19 In Martin, plaintiff and defendant purchased a home
20 together pursuant to an oral agreement under which each
21 contributed 50 percent of the down payment. Title was placed
22 in defendant's name, and defendant made the note payments in
23 lieu of rent. When plaintiff sued to enforce the agreement,
24 the trial court imposed a constructive trust for plaintiff's
25 benefit. The Court of Appeal approved the constructive trust
26 ruling, and further noted that a resulting trust arose,

1 yielding an alternative basis for affirmance. 193 Cal. Rptr.
2 317-18. Under the heading "A Resulting Trust Exists," the
3 court noted that "[i]ndeed, this is a classic case of a
4 resulting trust." Id.

5 Here, the bankruptcy court found that Cardinal and Cox
6 had orally agreed to purchase the property as "50-50 partners"
7 and to place legal title in Cox's name. Findings at 12.
8 Cardinal contributed 50 percent of the purchase price. Id. at
9 12-13. He and Cox agreed that he would provide 50 percent of
10 the expenses on the property, and Cardinal provided \$10,000
11 toward those expenses prior to the bankruptcy filings. Id. at
12 12, 14.

13 The bankruptcy court ruled, however, that the Ertas'
14 resulting trust defense could not succeed because their
15 position was no better than Cardinal's and the court would not,
16 in the exercise of its discretion, impose a trust in favor of
17 Cardinal. The court based this refusal on Cardinal's actions
18 vis a vis Cox and his conduct in this case. The court cited
19 Cardinal's refusal to explain satisfactorily why the property
20 had been placed in only Cox's name; his evasiveness and lack of
21 credibility as a witness; his extraordinary, cash-based mode of
22 transacting large business investments with Cox; and his
23 failure to have counsel of record in this proceeding, despite
24 the court's belief that he had consulted an attorney, and had
25 in fact been clandestinely advised by one during telephone
26 conferences. Exc. X, pp. 12-14.

1 Plaintiff contends the bankruptcy court's analysis can be
2 affirmed based on either of two equitable defenses to the
3 resulting trust: unclean hands or illegality (of the original
4 Cox-Cardinal contract).

5 The unclean hands doctrine is

6 rooted in the historical concept of [the] court of
7 equity [serving] as a vehicle for affirmatively
8 enforcing the requirements of conscience and good
9 faith. This presupposes a refusal to be 'the
10 abetter of iniquity.'

11 11 Witkin, Summary of California Law, Equity § 8, p. 684 (9th
12 Ed. 1990) (quoting Precision Instrument Mfg. Co. v. Automotive
13 Maintenance Machinery Co., 324 U.S. 806 (1945)).

14 Here, plaintiff cites Cardinal's fraud in forging the
15 Cox-to-Marko deed and absconding with the proceeds as having
16 tainted Cardinal with unclean hands. The Ertas are in turn
17 tainted also, plaintiff argues, by virtue of their standing in
18 Cardinal's shoes. Thus, plaintiff contends, the resulting
19 trust -- a creature of equity -- ought not be invoked for their
20 benefit.

21 Holding the Ertas accountable for Cardinal's conduct,
22 however, would cause the bankruptcy estate to be unjustly
23 enriched at their expense. If the trust is not recognized, the
24 estate recovers all of the property, although the debtor -- by
25 his own account -- never owned more than half of it. As a
26 further consequence, the Ertas, having once paid Cardinal full
value, would be required to pay a second time, in a money
judgment based (again) on the property's full value.

1 If the trust is upheld, by contrast, the estate's
2 recovery is limited to the debtor's 50% interest. The Ertas
3 still obtain only two-thirds of value. They paid Cardinal full
4 value, yet subsequently become liable to the trustee for the
5 estate's 50% interest.

6 Neither the bankruptcy court nor the parties have cited
7 authority directly addressing the question of whether the Ertas
8 should be held accountable for Cardinal's inequitable conduct.
9 It is not contended, however, that the Ertas share any actual
10 culpability with Cardinal. It is merely argued that the Ertas
11 should stand in Cardinal's shoes because their rights derive
12 from his. I disagree. Given the actual equities between the
13 parties before the court, refusing to recognize the trust would
14 be inconsistent with the unclean hands doctrine in that it
15 would facilitate the unjust enrichment of the bankruptcy estate
16 at the expense of an innocent party. It would also be
17 inconsistent with another equitable maxim, that disfavoring the
18 elevation of form over substance. See Witkin, supra, at §4, p.
19 682 ("Equity looks at substance rather than form").

20 Plaintiff next contends the original Cox/Cardinal
21 contract should not be enforced in equity due to its
22 illegality. In the Torrez case, the Ninth Circuit rejected
23 this defense in a similar context. There, debtor had taken
24 title to 120 acres of farm land purchased by the defendant,
25 giving rise to a resulting trust in defendant's favor. Title
26 had been taken in debtor's name for the sole purpose of

1 enabling defendant to violate statutory limits on allotments of
2 federally subsidized irrigation water. Debtor later undertook
3 to sell the property to finance its own reorganization,
4 contending that the resulting trust was void due to its illegal
5 purpose.

6 In rejecting the illegality defense in Torrez, the court
7 considered the following factors, which govern whether judicial
8 recognition is afforded to illegal agreements under California
9 law:

10 [1] The completed nature of the transaction, such
11 that the public can no longer be protected by
12 invocation of the rule that illegal agreements are
not to be enforced;

13 [2] the absence of serious moral turpitude on the
14 part of the party against whom the defense is
asserted;

15 [3] the likelihood that invocation of the rule will
16 permit the party asserting the illegality to be
unjustly enriched at the expense of the other
party; and

17 [4] disproportionality of forfeiture as weighed
18 against the nature of the illegality.

19 827 F.2d at 1299.

20 Here, plaintiff characterizes the agreement giving rise
21 to the trust as illegal by associating it with the unsavory
22 conduct of Cardinal as noticed by the bankruptcy court, i.e.
23 his cash-based, secretive business dealings and his invocation
24 of the fifth amendment in refusing to answer questions. Unlike
25 Torrez, there was no actual finding that the Cox-Cardinal
26 agreement was illegal. Even if it is presumed to be illegal,

1 however, application of the Torrez factors militates against
2 refusing to recognize the resulting trust.

3 First, even if the Cox-Cardinal agreement's purpose was
4 to frustrate federal law (such as by evading taxation), it is
5 not substantially different than the illegal agreement in
6 Torrez, which was enforced. Both cases involved frauds against
7 the government, but neither involved threats to human life or
8 health. Second, the Ertas, against whom the illegality defense
9 is now asserted, were not found to have engaged in immoral or
10 inequitable conduct. Even Cardinal acted without greater moral
11 turpitude than the corresponding party in Torrez, in so far as
12 the agreement to conceal his interest in the property is
13 concerned. Third, refusal to uphold the trust would, as
14 discussed previously, unjustly enrich the bankruptcy estate at
15 the Ertas' expense. This unjust enrichment factor was that
16 which the Torrez court found "most compelling" in its analysis.
17 827 F.2d at 1301-02. Finally, forfeiture is disproportionate
18 to the nature of the illegality, which has not even been
19 determined.

20 Plaintiff also argues that the Ertas did not satisfy
21 their burden of proof in establishing the resulting trust. The
22 party asserting a pro tanto resulting trust must establish with
23 definiteness and specificity the proportional amount
24 contributed. Loyds Bank California v. Wells Fargo Bank, 187
25 Cal. App. 3d 1038, 232 Cal. Rptr. 339, 342 (1986), rev. denied
26 (1987). The trust's existence must be proven by clear and

1 convincing evidence. Carr v. Yokohama Specie Bank, Limited, 99
2 F. Supp. 4, 7 (N.D. Cal. 1951), aff'd, 200 F.2d 251 (9th Cir.
3 1952).

4 In arguing that the Ertas failed to satisfy these
5 standards, plaintiff relies primarily on the discrepancies
6 between Cox's testimony (that he and Cardinal were 50-50
7 partners) and that of Cardinal and Nottoli (that Cox held all
8 of the property for Cardinal). The bankruptcy court resolved
9 that conflict completely in Cox's favor, finding his testimony
10 credible and unbiased. There was no dispute as to whether a
11 trust existed, and no evidence that the trust covered less than
12 50 per cent of the property. The earlier evidentiary conflict
13 over whether the trust extended to a greater portion of the
14 property does not undermine the Ertas' establishment of the pro
15 tanto trust.

16 Plaintiff finally argues that the trust is subject to
17 avoidance under the bankruptcy code in any event. Plaintiff
18 first asserts a theory based on § 544 and the hypothetical
19 premise that the estate took title to the property as a bona
20 fide purchaser. Under California law, a resulting trust can be
21 defeated by a bona fide purchaser without notice of the trust
22 interest. Matter of Torrez, 63 Bankr. at 754 (citing Cal. Civ.
23 Code § 856). Possession by another, however, constitutes
24 constructive notice of the rights of the person in possession,
25 precluding a bona fide purchaser from claiming it took without
26 notice. Id. Here, the bankruptcy court found that Cardinal

1 had begun collecting rent from the tenants on the property
2 prior to October 18, 1984, the date the bankruptcy petitions
3 were filed. See Findings at 22 (Cardinal began collecting rent
4 on October 4, 1984). This would constitute constructive notice
5 to the trustee of Cardinal's interest in the property, and thus
6 preclude its taking title as a bona fide purchaser and thus
7 avoiding the resulting trust. See Matter of Torrez, 63 Bankr.
8 at 754 (debtors were not bona fide purchasers where trust
9 beneficiary farmed the land and their farmhand lived on it).

10 Plaintiff next asserts a theory based on § 547.

11 Plaintiff argues that even if the trustee did not have bona
12 fide purchaser status, Cardinal's interest in the property was
13 not perfected until he began collecting rents, within the 90
14 day preference period preceding the bankruptcy filing. Section
15 547, however, allows the trustee to avoid a "transfer" made
16 within the preference period. 11 U.S.C. § 547(b)(2). There
17 was no transfer within that period here. To the extent
18 Cardinal has an interest, it had existed since the original
19 Nottoli-to-Cox/Cardinal sale.

20 I reverse the bankruptcy court on the resulting trust
21 question. I conclude that no standing issue was presented and
22 that a resulting trust in favor of Cardinal over a 50 %
23 interest arose from the facts of the original Notolli-to-Cox
24 transfer by operation of California law. Because the debtor
25 had not owned the 50 % equitable interest he held for Cardinal,
26 that interest was not property of the estate. The bankruptcy

1 court erred in entering judgment based on the full value of the
2 property.

3 2. Offset for Value of Defendants' Improvements

4 Plaintiff attacks as legal error the bankruptcy court's
5 allowance to defendants of a \$27,500 offset representing the
6 increase in the property's value which the court attributed to
7 defendants' improvements.

8 (1) Procedural Background

9 The bankruptcy court initially denied defendants' claim
10 to an equitable lien against the property in an amount
11 reflecting the value of the improvements. Findings at 60-63.
12 The court reasoned that California's "good faith improver"
13 statutes provide the exclusive remedy where the value of
14 improvements is sought by a holder of property who acted in
15 good faith. Id. at 61. The court then went on to allow
16 defendants a setoff for the increased value under Cal. Code of
17 Civ. Proc. § 741, one of the good faith improver statutes.
18 Findings at 63-74; 34-37. Section 741 provides for such
19 setoffs, under certain circumstances, against damages awarded
20 for the defendant's wrongful withholding of property.

21 In its letter opinion denying plaintiff's post-trial
22 motions, the court concluded it had erred in applying § 741.
23 Section 741 only allows setoff against a damages award.
24 Because the court had awarded plaintiff only the value of the
25 property, and no damages for withholding, it concluded § 741
26 was inapplicable. Exc. Y at 1. The bankruptcy court did not

1 disturb its result, however. The court reevaluated and
2 reversed its earlier conclusion that the statutory remedies for
3 good faith improvers are exclusive, and found that defendants
4 were entitled to an equitable lien against the property in the
5 same amount as the original \$ 741 setoff. Id. at 2-5.

6 (2) Exclusivity of Statutory Remedies

7 Plaintiff contends the court erred in reversing its
8 earlier ruling on the exclusivity of statutory remedies.
9 California courts have long held that the state's good faith
10 improver statutes preclude resort to general equitable
11 principles to grant good faith improvers remedies that are not
12 available by statute. See, e.g. Trower v. Rentsch, 94 Cal.
13 App. 168, 270 P. 749, 750 (1928) (equitable lien cannot be
14 imposed based on general equitable principles "when contrary to
15 the provisions of a positive statute."); see also, Taliaferro
16 v. Colasso, 139 Cal. App. 2d 903, 294 P.2d 774 (1954). In this
17 case, however, the bankruptcy court concluded that "a
18 California court would impress an equitable lien in favor of an
19 improver" if no statutory remedy was applicable. Exc. Y at 2.
20 In support, the court cited Jones v. Sacramento Savings and
21 Loan Ass'n, 248 Cal. App. 522, 56 Cal. Rptr. 741 (1967). Id.

22 The Jones court granted an equitable lien against a
23 residential subdivision in favor of a construction lender. The
24 construction lender mistakenly believed its lien had priority
25 over that of the (senior) purchase money lender. The
26 borrower/developer defaulted on both loans, and each lender

1 foreclosed. A quiet title action ensued in which the lenders
2 disputed priority. The court rejected the construction
3 lender's claim, but noted that unless an equitable lien were
4 imposed in its favor, the purchase money lender would be
5 unjustly enriched, because the value of the construction loan-
6 financed improvements far exceeded that of the land.

7 The Jones court invoked a general equitable doctrine
8 providing for "imposition of an equitable lien where the
9 claimant's expenditure has benefitted another's property under
10 circumstances entitling the claimant to restitution." 56 Cal.
11 Rptr. at 746. In its letter opinion, the bankruptcy court
12 invoked the same principle to impose a lien in favor of
13 defendants here. Exc. Y, at 2-3.

14 Jones, however, is not inconsistent with the rule that
15 good faith improvers must look to the statutes for their
16 remedies. It is not a good faith improver case. As the Jones
17 court itself noted in rejecting assertion of the exclusive
18 remedy rule, the good faith improver statutes apply to

19 one who makes improvements while 'holding' the
20 land, not to one who has supplied services to its
21 acknowledged owner or lent him money in reliance
upon a security instrument.

22 56 Cal. Rptr. at 748.

23 In rejecting plaintiff's assertion of the exclusivity
24 rule, the court also suggested another rationale on which its
25 ruling might be sustained. The court found plaintiff's
26 reliance on the Taliaferro case misplaced because that case had

1 been decided before the enactment of Cal. Civ. Proc. Code §
2 871. Exc. Y at 4. Section 871 is another good faith improver
3 statute. Taliaferro applied the exclusivity rule to conclude
4 that an offset could not be granted on general equitable
5 principles where there were no damages to be setoff, and thus
6 no available right to setoff under section 741. Unlike § 741
7 and Taliaferro, however, the later-enacted § 871 authorizes
8 granting relief to good faith improvers even in the absence of
9 a damages award, where the good faith improver asserts an
10 affirmative claim or counterclaim under § 871. Id. (citing
11 California Law Revision Commission Comment to Section 871.1
12 (1968)). Such claims are subject to a one year statute of
13 limitations. Cal. Civ. Proc. Code § 340(5).

14 It does not follow from the fact that Taliaferro was
15 decided prior to the adoption of § 871 that California's good
16 faith improver statutes no longer provide improvers their
17 exclusive remedies. Rather, that sequence indicates only that
18 statutory relief that was not available when Taliaferro was
19 decided is now available under § 871.

20 (2) Section 871 Statutory Relief

21 Defendants suggest the offset could be sustained based on
22 § 871. I disagree. Defendants did not plead a § 871
23 counterclaim below, and neither of their alternative arguments
24 for avoiding the one year statute of limitations is persuasive.
25 They first suggest that the limitations statute should not be
26 applied to a counterclaim asserted solely for purposes of

1 setoff. Response at 37-38 (citing Minelian v. Manzella, 215
2 Cal. App. 3d 457, 263 Cal. Rptr. 597 (1989)). The doctrine of
3 setoff, however, is equitable in nature. A § 871 counterclaim,
4 by contrast, is legal in nature; it is based on a special
5 statute and subject to a specific limitations period.

6 Defendants next suggest that a § 871 claim was implied in
7 the good faith improver affirmative defense they pled. That
8 defense, however, asserted only a right "to set off against any
9 damages;" it cannot reasonably be read as implying an
10 affirmative § 871 counterclaim. Exc. B, para. 52, at 8.
11 Further, to construe it as such would be prejudicial to the
12 plaintiff, as both parties proceeded at trial on the
13 understanding the defense was premised on § 741, without
14 addressing the procedures and standards which govern a § 871
15 claim.

16 I reverse the bankruptcy court's ruling awarding an
17 offset to defendants for the value of their improvements to the
18 property. The court erred in imposing an equitable lien.
19 California law limits good faith improvers to their statutory
20 remedies. Defendants were not entitled to relief under Cal.
21 Code Civ. Proc. § 741, and failed to assert a timely
22 counterclaim under § 871.

23 b. Setoff for Pre-Existing Encumbrances

24 Plaintiff next attacks as legal error the allowance to
25 defendants of a \$99,208.45 offset representing the amounts paid
26 at closing to satisfy existing encumbrances on the property.

1 (1) The Bankruptcy Court's Analysis

2 The bankruptcy court allowed this offset based on its
3 conclusion that the Ertas' purchase money lender, Watsonville
4 Federal Savings and Loan (Watsonville Federal), was entitled to
5 equitable subrogation. Under the doctrine of equitable
6 subrogation, a special status is afforded to one who pays off
7 an encumbrance on realty at the instance of the owner of the
8 property or the holder of the encumbrance based on an
9 understanding that the money advanced will be secured by a
10 first lien on the property. If the new security is later
11 revealed to not be the first lien on the property, its holder,
12 if not chargeable with culpability or inexcusable neglect, will
13 be subrogated to the rights of the prior encumbrancer under the
14 security it holds. Katsivalis v. Serrano Reconveyance Co., 70
15 Cal. App. 3d 200, 138 Cal. Rptr. 620, 625 (1977). The lender
16 who advanced the funds is viewed, in equity, as the assignee of
17 the prior encumbrance, in consideration of the money advanced.
18 Id. (citing Swift v. Kraemer, 13 Cal. 526, 530 (1858)).

19 Here, the bankruptcy court found Watsonville Federal was
20 entitled to the benefit of equitable subrogation based on its
21 having provided the Ertas the financing to pay off the
22 encumbrances on the property at closing. The Ertas were to be
23 listed on the title as the owners, and they agreed with
24 Watsonville Federal that it would have a first lien on the
25 property upon release of the prior encumbrances. Findings at
26 76.

1 The court rejected plaintiffs' contention that
2 Watsonville Federal was chargeable with culpable and
3 inexcusable neglect. To the contrary, the court found,

4 Watsonville [Federal] followed its standard
5 operating procedure in processing this loan
6 application; . . . [it] had no contact with
7 Bergstrom about this property; . . . [it] had no
8 knowledge of any ownership interest Cardinal may
9 have claimed . . . ; . . . [it] did not know Tamara
10 Marko; . . . [it] had no discussions with Ray and
11 Linda Erta about the prior ownership of the
12 property; . . . did not review the chain of title
13 . . . ; and . . . [it] had no actual knowledge of
14 the Cox claim to the property until served with the
15 complaint in this lawsuit.

16 Id. at 77. Having found their lender entitled to equitable
17 subrogation, the court concluded that if the Ertas retained the
18 property, their liability should be reduced to reflect the
19 payment of the encumbrances, as those amounts inured to the
20 benefit of the estate. Findings at 78.

21 (2) Was Equitable Subrogation Properly Allowed?

22 Plaintiff first contends the subrogation doctrine was
23 inapplicable because the true owner of the property, Cox or his
24 bankruptcy trustee, was not involved in obtaining the financing
25 from Watsonville Federal. This argument is unpersuasive.
26 While it factually distinguishes Katsivalis, it does not
27 undermine the availability of subrogation. The Watsonville
28 property was encumbered to the extent of the offset prior to
29 (and wholly apart from) the fraudulent transfer to Marko.
30 Watsonville Federal's satisfaction of the encumbrances
31 therefore benefitted the bankrupt estate.

1 The essential rationale of the equitable subrogation
2 doctrine in this context is that equity

3 "[will] not permit [the estate] to take
4 [Watsonville Federal's] money and apply it in
5 extinguishment of a prior incumbrance, and then
6 claim that the property should neither be bound by
7 the new mortgage nor the old."

8 Katsivalis, 138 Cal. Rptr. at 625 (quoting Swift, supra, 13
9 Cal. at 530). It is in these circumstances that equity
10 considers "'the substance of the transaction [to] be an
11 assignment of the old mortgages in consideration of the money
12 advanced.'" Id.

13 That the encumbrances pre-existed the void transfer also
14 distinguishes this case from those cited by plaintiff for the
15 proposition that encumbrancers are not entitled to relief where
16 they lend on a forged or otherwise void deed. See e.g. Bryce
17 v. O'Brien, 5 Cal.2d 615, 55 P.2d 488 (1936); Trout v. Taylor,
18 220 Cal. 652, 32 P.2d 968 (1934).

19 Plaintiff further argues this case should be governed by
20 Huse v. Den, 85 Cal. 390, 24 P. 790 (1890). In Huse, the
21 California Supreme Court denied equitable subrogation to a
22 purchaser of land from the executor of a probate estate. The
23 land sale was void because done without the required approval
24 of the probate court. Subrogation was denied primarily because
25 the purchasers had been warned not to purchase without the
26 probate court's sanction, and knew of the executor's lack of
power to sell without it. "They were not therefore, ignorant
purchasers in good faith, to whom the doctrine of subrogation

1 would, under any circumstances apply." 24 P.2d at 791.

2 Moreover, the Huse court noted, the purchasers' money was paid
3 to the executor and not to the heirs, and was commingled with
4 other estate funds. Id.

5 Relying on the court's allusion to "ignorant purchasers
6 in good faith," plaintiff argues Huse stands for the
7 proposition that constructive notice of outstanding claims
8 defeats an encumbrancer's entitlement to equitable subrogation.
9 Because the record chain of title contained the "suspicious"
10 quitclaim deed from the Coxes to Marko, plaintiff contends, and
11 because Cardinal's possession of the property could have been
12 discerned by a reasonable inspection, Watsonville Federal
13 should be charged with notice of adverse claims and thereby
14 rendered ineligible for equitable subrogation.

15 Huse did not turn on constructive notice, but rather
16 actual notice. Further, the more recent Katsivalis decision
17 allows subrogation where the party invoking it is "not
18 chargeable with culpable and inexcusable neglect." 138 Cal.
19 Rptr. at 625. That standard is consistent with the result in
20 Huse. The bankruptcy court reasonably found that Watsonville
21 Federal was not chargeable with such neglect.

22 I affirm the Bankruptcy court's allowance to defendants
23 of the offset reflecting satisfaction of prior encumbrances.
24 Equitable subrogation was properly invoked.

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CONCLUSION

The bankruptcy court's ruling is affirmed in part,
reversed in part, and remanded for adjustment of the judgment
in accordance with this Opinion.

DATED this 2nd day of February, 1993.

Michael R. Hogan
MICHAEL R. HOGAN
United States District Judge

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U.S. DISTRICT COURT
DISTRICT OF OREGON

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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF OREGON

In re)	CV-92-6132-HO
)	
S.D. COX INVESTMENTS, INC.,	)	Bankruptcy Court
STEVEN D. COX, DEBORAH M. COX, and	)	Case Nos. 684-08450-H7
EUGENE R. RICHMOND JR.,	)	684-08496-H7
	)	684-08497-H7
Debtors.	)	684-08498-H7
<hr/>		
PAUL LANSDOWNE, INC., Trustee,	)	Adversary Proceeding No.
	)	687-5025-H
Plaintiff-Appellant,)	
vs.	)	O R D E R
TAMARA MARKO, et al.,)	
)	
Defendant-Appellees.)	

Hogan, J.:

The bankruptcy court's ruling awarding judgment to plaintiff is affirmed in part, reversed in part, and remanded for

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adjustment of the judgment in accord with the accompanying
Opinion. The request for oral argument is denied.

IT IS SO ORDERED.

DATED this 2nd day of February, 1993.

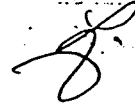

MICHAEL R. HOGAN
United States District Judge

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U.S. DISTRICT COURT
DISTRICT OF OREGON
EUGENE, OREGON



**UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF OREGON**

In re:
S.D. COX INVESTMENTS, INC.,
STEVEN D. COX, DEBORAH M. COX, and
EUGENE R. RICHMOND JR.,

Debtors.

Civil No. 92-6132-HO

PAUL LANSDOWNE, INC., Trustee
Plaintiff-Appellant,

vs

TAMARA MARKO, et al.,
Defendant-Appellees.

Bankruptcy Nos.

684-08450-H7

684-08496-H7

684-08497-H7

684-08498-H7

Adversary No. 687-5025-H

JUDGMENT

The Bankruptcy court's ruling awarding judgment to plaintiff is affirmed in part, reversed part, and remanded for adjustment of the judgment in accord with the accompanying Opinion.

Dated: February 3, 1993.

Donald M. Cinnamond, Clerk

Lea Force
by

Lea Force, Deputy

JUDGMENT

DOCUMENT NO: _____