In the United States Bankruptcy Court

for the Northern District of Iowa

Western Division

HAROLD E. NESSET and
MARY L. NESSET
Debtor(s).

Bankruptcy No. 00-02143M

Chapter 7

ORDER RE: OBJECTIONS TO EXEMPTIONS

Creditor Ronald S. Nesset objects to the debtors' claims of exemptions. Hearing on the objection was held November 29, 2000. J. Mathew Anderson appeared for the debtors, Harold E. Nesset and Mary L. Nesset. Larry S. Eide appeared for objector Ronald Nesset. The court now issues its findings of fact and conclusions of law as required by Fed.R.Bankr.P. 7052. This is a core proceeding under 28 U.S.C. § 157(b)(2)(B).

Findings of Fact

Harold and Mary Nesset filed a joint Chapter 7 petition on August 23, 2000. They listed a joint debt of $391,047.90 to Ronald Nesset in their bankruptcy schedule of unsecured creditors. Harold and Ronald are half-brothers. Ronald's claim relates to the disposition of 120 acres of farm land (the "120 acres") in Winnebago County, Iowa, formerly owned by their father, Stanley Nesset. The property is legally described as:

> The South Half (S 1/2) of the Southeast Quarter (SE 1/4) of Section Thirteen (13), Township Ninety-Eight (98) North, Range Twenty-Four (24) West of the 5th P.M., and the Northeast Quarter (NE 1/4) of the Southeast Quarter (SE 1/4) of Section Thirteen (13), Township Ninety-Eight (98) North, Range Twenty-Four (24) West of the 5th P.M.

Stanley Nesset died intestate in 1967, leaving no surviving spouse. His only heirs were three sons, Harold Nesset, Ronald Nesset and Donald Nesset. The sons each thus acquired an undivided one-third interest in the 120 acres.

On February 23, 1989, Donald Nesset, a resident of California, died intestate. Harold Nesset served as administrator of Donald's estate in proceedings in the California Superior Court for Ventura County. The estate included approximately $150,000 in cash, other personal property, and Donald's undivided one-third interest in the 120-acre farm in Iowa. Harold Nesset represented to the California probate court that he was the sole heir of Donald Nesset and, unbeknownst to Ronald, took all the assets of the estate for himself.

In August 1991, Harold and Mary Nesset paid Ronald Nesset approximately $50,500 for Ronald's one-third interest in the farm. They acquired the purchase money by borrowing against their home in Thousand Oaks, California. The deed mistakenly described a transfer of 40 acres, namely the northeast quarter of the above-described quarter-section of Section 13, rather than an undivided one-third interest in 120 acres. Exhibit D.

Harold and Mary Nesset later sold their California home and moved to Iowa. They lived in rental housing in Forest City from June 1993 to the fall of 1995. During 1994 and 1995, they built a home in the southwest quarter of the above-described quarter-section of Section 13. They occupied the property as their homestead beginning in the fall of 1995.

In 1996, Ronald Nesset brought an action against Harold and Mary Nesset in the California Superior Court for Ventura County, making claims arising from the administration of Donald Nesset's estate. In February, 1998, the matter was tried to a jury; Harold and Mary were present at trial. On March 2, the jury returned a special verdict and supplementary verdict. On March 13, the court issued its Money Judgment and Decree Imposing Constructive Trust. The court held Harold Nesset liable to Ronald Nesset for "fraud and deceit, negligent misrepresentation, and for conversion" and entered judgment for $210,277 plus costs of suit. The court further found Harold Nesset "guilty of fraud, malice or oppression" and entered judgment for an additional $100,000 as punitive damages. Exhibit 1, ¶¶ 1-5.

The order provided further:

> 6. With respect to the Fourth Cause of action for an accounting and for the imposition of a Constructive Trust, the Court adopts the Special Verdict of the Jury for purposes of performing an accounting and finds that the defendants owe to the plaintiff the sum of Two Hundred and Ten Thousand Two Hundred Seventy Seven Dollars ($210,277).
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> 7. The defendant HAROLD E. NESSET, obtained said sums through fraud and breach of a fiduciary duty, and said defendant and MARY L. NESSET, and each of them retained said sums by mistake which sum was wrongfully retained by said defendant(s), and/or used by them to purchase personal property and to construct a home and improve a 120-acre farm located in Forest City, Iowa, the legal description for which is as follows:
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> The South Half (S 1/2) of the Southeast Quarter (SE 1/4) and the Northeast Quarter (NE 1/4) of the Southeast Quarter (SE 1/4) of Section Thirteen (13), Township Ninety-Eight (98) North, Range Twenty-Four (24) West of the Fifth Principal Meridian, Winnebago County, Iowa.
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> 8. Pursuant to the provisions of sections 2223 and 2224 of the California Civil Code, the Court hereby orders and decrees that the defendants, HAROLD E. NESSET and MARY L. NESSET, are the constructive trustees and hold all property owned by them, whether real or personal and wherever situated, in trust for the benefit of the plaintiff, RONALD L. NESSET, until such sum of Two Hundred and Ten Thousand Two Hundred and Seventy Seven Dollars ($210,277) is delivered and paid to RONALD S. NESSET.

Exhibit 1, ¶¶ 6-8. Harold and Mary Nesset did not appeal the decision. On March 31, 1998, a transcript of the California judgment was filed with the clerk of court in the Iowa District Court for Winnebago County. Exhibit 2.

Because Donald Nesset's one-third interest in the 120-acre farm had never been probated in Iowa, Ronald Nesset, in 1996, brought a quiet title action in the Iowa District Court for Winnebago County, naming Harold Nesset and Mary Nesset as defendants. The matter was resolved by stipulation to the effect that Donald's one-third interest in the 120 acres would be divided equally between Ronald and Harold. By order issued June 22, 1999, the Iowa District Court adopted the stipulation as a settlement of all claims in the action. Exhibit 4.

Ronald Nesset made a number of attempts to collect the debt owed him. A sheriff's sale was scheduled for August 25, 2000. Exhibit 2. Harold and Mary Nesset filed their bankruptcy petition on August 23, staying the sale.

On their bankruptcy schedule of real property, Harold and Mary Nesset listed an undivided five-sixths interest in the 120 acres of farm land in Winnebago County. They claimed a homestead exemption in their interest in the 40 acres where their home is located. The entire 120 acres is subject to a mortgage lien held by Manufacturer's Bank and Trust, Forest City. The balance on the loan is approximately $95,000. Part of the original mortgage loan was used to construct the home.

Harold and Mary Nesset scheduled personal property valued at a total of $10,475. They claimed the following personal property exempt:

1980 Ford Ranger	$ 400
20 gauge shotgun	50
410 gauge shotgun	50
checking account	75
clothing	750
Cub Cadet 48" riding law mower	500
Household goods & furnishings	3,000

Exhibit 3, Schedule C. Debtors' personal property also includes an over-encumbered 1992 Cadillac valued at $5,500. They have owned the shotguns for 15 to 20 years. They acquired the lawn mower and 1980 Ford Ranger in 1994. The household goods and furnishings listed in their schedules are the same items they owned on the date of the California judgment.

Discussion

Ronald Nesset objects to the debtors' claims of exemptions in their entirety. He contends that he is the true owner of the property by virtue of the California judgment creating a constructive trust. Harold and Mary Nesset argue that the California court lacked jurisdiction over their property in Iowa and did not have authority to eliminate their Iowa exemptions. Ronald Nesset bears the burden of proving that the debtors' exemptions are not properly claimed. Fed.R.Bankr.P. 4003(c).

A constructive trust is an equitable remedy that confers on the rightful owner an equitable interest in property in order to prevent unfairness and unjust enrichment. N.S. Garrott & Sons v. Union Planters National Bank of Memphis (In re N.S. Garrott & Sons), 772 F.2d 462, 467 (8th Cir. 1985). The imposition of a constructive trust on a bankruptcy debtor's property gives the true owner an equitable interest superior to that of the debtor or trustee. Id. Only the property interest that remains with the debtor becomes property of the bankruptcy estate. Id.; Drexel Burham Lambert, Inc. v. Flight Transp.

Corp. (In re Flight Transp. Corp. Securities Litigation), 730 F.2d 1128, 1136 (8th Cir. 1984); see generally 5 Collier on Bankruptcy ¶ 541.11[3] (15th ed. rev. 2000).

Because the removal of property from the estate conflicts with the bankruptcy principle of equitable distribution for all creditors, a bankruptcy court must be cautious in recognizing the existence of a constructive trust. The Sixth Circuit has held that a creditor must obtain a pre-bankruptcy judicial decision declaring the existence of a constructive trust before the bankruptcy court may recognize the trust and determine that property subject to the trust did not become property of the estate. McCafferty v. McCafferty (In re McCafferty), 96 F.3d 192, 196-97 (6th Cir. 1996); XL/Datacomp, Inc. v. Wilson (In re Omegas Group, Inc.), 16 F.3d 1443, 1451 (6th Cir. 1994). In In re N.S. Garrott & Sons, 772 F.2d at 467, the Eighth Circuit, applying the law of Arkansas, recognized a constructive trust even in the absence of prior state court action. See also Bank of Alex Brown v. Goldberg (In re Goldberg), 158 B.R. 188 (Bankr. E.D. Cal. 1993), aff'd, 168 B.R. 382 (B.A.P. 9th Cir. 1994) (imposing constructive trust in creditor's adversary proceeding in Chapter 13 case). Because Ronald Nesset obtained a decree imposing a constructive trust prior to Harold and Mary Nesset's bankruptcy filing, this court need not address whether it could recognize a constructive trust under a less strict standard.

Section 1738 of title 28 of the U.S. Code implements the full faith and credit clause of the United States Constitution, Article IV, Section 1. Pursuant to § 1738, all federal courts must give the same full faith and credit to state court judgments as they would have in the courts of the state from which the judgments were taken. Gouveia v. Tazbir, 37 F.3d 295, 300 (7th Cir. 1994); In re Freese, 119 B.R. 1019, 1022 (Bankr. N.D. Iowa 1990).

A final, valid judgment is subject only to jurisdictional challenges, not collateral attack, even if the deciding court made a mistake. Error is to be corrected by appeal. Spartan Mills v. Bank of America Illinois, 112 F.3d 1251, 1255 (4th Cir. 1997), cert. denied, 118 S.Ct. 417 (1997); see also In re Slater, 200 B.R. 491, 495 (E.D.N.Y. 1996) ("bankruptcy court may look behind a state court judgment only if that judgment was procured by fraud or collusion, or where the rendering court lacked jurisdiction"). California courts would apply the same finality principles to their own decisions:

> Collateral attack is proper to contest lack of personal or subject matter jurisdiction or the granting of relief which the court has no power to grant. . . . Nonjurisdictional errors, however, are not appropriate procedural targets within this context. Thus, a failure to state a cause of action . . . insufficiency of evidence . . . abuse of discretion . . . and mistake of law . . . have been held nonjurisdictional errors for which collateral attack will not lie.

Armstrong v. Armstrong, 15 Cal.3d 942, 950 (1976) (citations omitted).

Harold and Mary Nesset first contend that the California Superior Court lacked jurisdiction over their Iowa real estate. As a general principle, it is true that "the courts of a state cannot create an interest in real estate situated in another state; nor can they adjudicate the title or control the devolution of such real estate; that is, the decree or judgment in one state cannot act directly on land in another state." Meents v. Comstock, 230 Iowa 63, 296 N.W. 721, 724 (1941). However, the case of Meents v. Comstock illustrates an exception to this general rule.

In that case, Comstock devised Illinois and Iowa farm land to his children, who then operated the farms through a partnership. Several years later, the partnership had accumulated a substantial amount of debt. The partners entered into a trust agreement for the purpose of operating the farms and paying

claims, in an effort to avoid bankruptcy. Under the terms of the agreement, the Illinois Circuit Court confirmed the trust and appointed a trustee, Meents. Near the end of the 10-year term of the trust, the Illinois court entered a decree for the orderly liquidation of the trust estate. In an Iowa action, Meents petitioned for sale of the Iowa farm land. George Comstock objected. The Iowa trial court held that the Illinois court lacked jurisdiction to order sale of the Iowa real property. The Iowa Supreme Court reversed. The court recognized the general rule, quoted above, but added that an important exception applied to the case before it. "[I]n cases of trust a court of equity, if it has jurisdiction of the proper litigants, may enforce the trust by a decree in personam directing the conveyance of lands situated in another state." Id.

Iowa case law makes clear that the exception is not limited in application to express trusts. In an early case, MacGregor v. MacGregor, 9 Iowa 65, 1859 WL 320 (1859), the court gave effect to a New York judgment relating to a trust that affected interests in Iowa real property. Citing Massie v. Watts, 6 Cranch 148, 160 (1810), the court stated:

> [I]n cases of fraud, of trust or of contract, the jurisdiction of a court of chancery is sustainable wherever the person may be found, although lands not within the jurisdiction may be affected by the decree. When the case, however, involves a naked question of title, the courts of a State other than that where land is situated, cannot sustain their jurisdiction. But when the question changes its character, when the defendant is liable to the plaintiff either in consequence of contract, or as a trustee, or as the holder of a legal title acquired by any species of mala fides practiced on the plaintiff, the principles of equity give a court jurisdiction wherever the person may be found, and the circumstance that a question of title may be involved in the inquiry and may even constitute the essential point on which the case depends, does not seem sufficient to arrest that jurisdiction.

1859 WL 320, *7. The court explained further:

> The jurisdiction is sustained upon the principle that in all cases in equity the primary decree is in personam and not in rem, and that in these cases peculiarly the courts having authority to act upon the person may make decrees not binding the land itself, but the conscience of the party in regard to the land, and compel him to perform his contract, execute his trust, or answer for the fraud according to conscience and good faith. . . . [W]hile a decree cannot operate as a conveyance of land out of the State, as it does under the statute within the State, yet this is a matter which does not affect the jurisdiction. Having jurisdiction of the parties by a voluntary appearance, the court may decide the controversy between them, and effect may be given to the decree as the law shall authorize.

Id. at *8.

Harold and Mary Nesset do not claim that the California Superior Court had no jurisdiction over them personally. They appeared and defended the complaint. Ronald Nesset's claim for the imposition of a constructive trust sought an equitable remedy for wrongful conduct. The decree imposing the constructive trust affected Harold and Mary's real property in Iowa, because it gave Ronald Nesset the right to have the property transferred to himself. Communist Party of the United States v. 522 Valencia, Inc., 35 Cal.App.4th 980, 990 (1995). The decree did not operate as a direct conveyance of the property. Thus, the case was within the rule recognized in Iowa in Meents v. Comstock and MacGregor v. MacGregor. The California court, acting in equity and having in personam jurisdiction

over Harold and Mary Nesset, had authority to enter a decree affecting their real property located in Iowa. The bankruptcy court must treat the California judgment and decree as a final, valid order with preclusive effect.

Debtors next contend that the California Superior Court could not have invalidated their exemptions under Iowa law. No money judgment was entered against Mary Nesset. Moreover, there was no finding of fraud by Mary Nesset; she was not involved in the administration of Donald Nesset's estate. Harold Nesset originally acquired an interest in the 120 acres by devise from his father and later by purchase from Ronald Nesset. Debtors argue that the California court did not have authority to impose a constructive trust on property that was not acquired fraudulently. They argue further that Ronald Nesset has not shown that the assets claimed exempt were acquired fraudulently.

These arguments appear to be an attempt to limit the extent of the constructive trust through collateral attack on the judgment. Nevertheless, this court will examine the arguments in the context of California law in order to establish that they do not involve jurisdictional matters.

A constructive trust, under California law, is "an equitable remedy imposed to prevent unjust enrichment and enforce restitution, under which one who wrongfully acquires property of another holds it involuntarily as a constructive trustee, and the trust extends to property acquired in exchange for that wrongfully taken." Goldberg v. Bank of Alex Brown (In re Goldberg), 168 B.R. 382, 384 (B.A.P. 9th Cir. 1994) (quoting Pacific Lumber Co. v. Superior Court, 226 Cal.App.3d 371 (1990)). The principles of constructive trust law in California are codified in the state's Civil Code. "One who wrongfully detains a thing is an involuntary trustee thereof, for the benefit of the owner." Cal. Civ. Code § 2223. "One who gains a thing by fraud, accident, mistake, undue influence, the violation of a trust, or other wrongful act, is, unless he or she has some other and better right thereto, an involuntary trustee of the thing gained, for the benefit of the person who would otherwise have had it." Cal. Civ. Code § 2224. Three conditions for imposition of a constructive trust are "(1) the existence of a res (property or some interest in property); (2) the right of a complaining party to that res; and (3) some wrongful acquisition or detention of the res by another party who is not entitled to it." Communist Party v. 522 Valencia, 35 Cal.App.4th at 990.

It is irrelevant that a money judgment was not entered against Mary Nesset. The court imposed a constructive trust against her property to the extent of $210,277. Exhibit 1, ¶¶ 6-8. Mary Nesset did not appeal the order. Nor is it relevant that there was no finding of fraud by Mary Nesset. The California Civil Code provides that a constructive trust may be imposed for acquiring property by "fraud, accident, mistake, undue influence, the violation of a trust, or other wrongful act . . . ." Cal. Civ. Code § 2224. Thus, California law permits a decree imposing a constructive trust for acts of negligence. Taylor Associates v. Diamant (In re Advent Management Corp.), 104 F.3d 293, 296 (9th Cir. 1997) (quoting Mitsui Mfrs. Bank v. Unicom Computer Corp. (In re Unicom Computer Corp.), 13 F.3d 321, 325 (9th Cir. 1994)). The wrongful conduct justifying imposition of a constructive trust need not amount to fraud. In re Goldberg, 168 B.R. at 384; see also Loschen v. Clark, 256 Iowa 413, 127 N.W.2d 600, 603 (1964) (same, under Iowa law).

The balance of the debtors' argument relates to tracing. Nessets challenge the authority of the California court to impose a constructive trust on all of Harold and Mary's property, without finding that specific property was wrongfully acquired. In that regard, the California court made this finding:

> The defendant HAROLD E. NESSET, obtained [the sum of $210,277] through fraud and breach of a fiduciary duty, and said defendant and MARY L. NESSET, and each of them retained said sums by mistake which sum was wrongfully retained by said defendant(s),

> and/or used by them to purchase personal property and to construct a home and improve a 120-acre farm located in Forest City, Iowa. . . .

Exhibit 1, ¶ 7. The court then imposed a constructive trust on all of Harold Nesset's and Mary Nesset's property, "whether real or personal and wherever situated" until $210,277 is paid to Ronald Nesset. Id., ¶ 8.

The California decree appears to be a finding that the debtors acquired the means to build their home through fraud and breach of fiduciary duty by Harold, and that for either Harold or Mary to keep the home without the debt to Ronald being paid would be an unjust enrichment. This finding would justify imposing a constructive trust on the homestead property, preventing the debtors from acquiring an interest in the homestead superior to Ronald Nesset's interest. Under the law of constructive trust, the trust relationship arises as of the date of the wrongful detention of property. This principle prevents the debtor from acquiring exempt property with funds that are deemed to have been held in trust. Bank of Alex Brown v. Goldberg (In re Goldberg), 158 B.R. 188, 196 (Bankr. E.D. Cal. 1993), aff'd, 168 B.R. 382 (B.A.P. 9th Cir. 1994). Denying the homestead exemption in these circumstances is consistent with Iowa exemption law, which permits denial of exemptions when the property claimed exempt was acquired with wrongfully obtained funds. See Eide v. Rodemeyer (In re Rodemeyer), 99 B.R. 416, 423-24 (Bankr. N.D. Iowa 1989) (denying claim of exemption in life insurance to extent acquired with converted proceeds of collateral); Cox v. Waudby, 433 N.W.2d 716, 718-19 (Iowa 1988) (homestead nature of property does not prevent tracing of proceeds of constructive trust into the property; homestead interest is not created in property acquired with wrongfully obtained funds).

Harold and Mary Nesset may argue that the California court did not trace funds directly from Donald Nesset's estate into their home or other property. In some circumstances, California courts will impose a constructive trust applying liberal tracing standards. In In re Goldberg, 158 B.R. 188, the debtor received a duplicate refund of about $17,000 through the mistake of an escrow agent. He commingled the funds with amounts in existing bank accounts, and later used the accounts to make a $15,000 down payment on a home. Creditor brought an adversary proceeding to impose a constructive trust on debtor's home and to foreclose on its interest in the property. After discussing the liberal tracing rule announced in Mitchell v. Dunn, 211 Cal. 129 (1930), the bankruptcy court examined the evidence under the more strict standard applicable under California law when the defendant is insolvent. In re Goldberg, 158 B.R. at 195-96. The bankruptcy court determined that the creditor had not demonstrated direct and specific tracing of the fund to the debtor's residence. Id. at 196. Nevertheless, the court imposed a constructive trust on the home in the amount of $15,000, because it determined that creditors would not be prejudiced. The commingled funds had been invested in an exempt asset to which other creditors would not have had access. The Bankruptcy Appellate Panel for the Ninth Circuit affirmed the decision, concluding that "it is not an abuse of discretion to allow liberal tracing when no creditors will be harmed." In re Goldberg, 168 B.R. 382, 385 (B.A.P. 9th Cir. 1994).

The Goldberg case demonstrates that California law may permit the imposition of a constructive trust under liberal tracing standards even when the defendant is insolvent. Harold and Mary's tracing argument questions the extent of the constructive trust. It is a claim that the California Superior Court, by imposing the constructive trust on all their property, abused its discretion or made a mistake of law. This court concludes that the argument is a non-jurisdictional challenge that could have been raised on appeal and that may not be made now through collateral attack. Armstrong v. Armstrong, 15 Cal.3d 942, 950 (1976).

Debtors finally contend that their exemptions should not be denied unless there is evidence that particular assets were wrongfully acquired. The court disagrees. Because the constructive trust was imposed against all of Harold and Mary's property without exception, Ronald needed to show only that the property claimed exempt was existing at the time of the California decree. This was proved as to the homestead, the lawn mower, the 1980 Ford Ranger, the two shotguns, and household goods. There was no evidence as to whether the debtors' scheduled checking account or clothing were in existence at the time of the California decree.

The decree imposing a constructive trust on Harold and Mary's property created an equitable interest in Ronald Nesset that did not become property of the estate. In re N.S. Garrott & Sons, 772 F.2d at 467; 11 U.S.C. § 541(d). Property subject to the constructive trust is not exempt from Ronald's claim. However, the California court placed a limitation on the constructive trust. Harold and Mary have the right to retain property remaining after the payment of the debt to Ronald. Thus, they have an equitable interest in the property. Their limited equitable interest is the only property interest that became property of the bankruptcy estate. 11 U.S.C. § 541(d). The debtors may properly claim this interest exempt from their general unsecured creditors.[(1)]

Iowa Code § 561.21 creates a marshaling rule that requires collection of debt from other assets prior to executing on the homestead. Applying the rule in this situation would not prevent sale of the homestead. Although no valuation evidence was presented at the hearing, the schedules indicate that non-exempt property is not adequate to satisfy Ronald's claims. The non-homestead 80 acres are subject to a mortgage and Ronald's judgment lien for punitive damages.

ORDER

IT IS ORDERED that Ronald Nesset's objection to exemptions is overruled in part and sustained in part. The objection is overruled as to the debtors' claims of exemptions in their checking account and clothing.

IT IS FURTHER ORDERED that Ronald Nesset's objection to exemptions as to the debtors' claims of exemptions in their homestead, Cub Cadet riding lawn mower, 1980 Ford, and household goods and furnishings is sustained.

IT IS FURTHER ORDERED that the debtors' remaining equitable interests in their homestead, Cub Cadet riding lawn mower, 1980 Ford, and household goods and furnishings are exempt from general unsecured creditors other than Ronald Nesset.

SO ORDERED THIS 1st DAY OF FEBRUARY 2001.

William L. Edmonds
U.S. Bankruptcy Judge

1. Mary Nesset's lack of record title to the homestead property does not affect the outcome of this matter. If she acquired an ownership interest in the homestead in 1991, the homestead is still subject to Ronald's claim because of the constructive trust. If she did not, her homestead rights are still exempt from general unsecured creditors because a homestead may not be split. Merchants Mutual Bonding Co. v. Underberg, 291 N.W.2d 19 (Iowa 1980).