

2/17/04

**UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION**

IN THE MATTER OF:	:	CASE NUMBER: A01-66915-PWB
	:	
JULIET RENEE COTTON,	:	
	:	IN PROCEEDINGS UNDER
	:	CHAPTER 7 OF THE
Debtor.	:	BANKRUPTCY CODE

ORDER

This matter comes before the Court on the issues raised by the Motion to Sell Real Estate filed by Chapter 7 Trustee Barbara Stalzer ("Trustee"), and the objections thereto filed by Oscar Hudson and Quality Grain Company, Inc. ("Hudson," "QGCI," and, collectively, the "Objectors"). Hudson and QGCI object to the Trustee's proposed sale of certain real property located in Tunica, Mississippi because they assert that the property is held in constructive trust for them and, therefore, is not property of the estate under 11 U.S.C. § 541(d). Bearing on the determination of this matter is the issue of whether the Trustee may avoid any equitable interest Objectors may have as constructive trust beneficiaries using the "strong-arm" avoidance powers of § 544(a). The Court took this matter under advisement after a hearing held on September 16, 2003, and requested briefing of the issues by the parties. The issues involved herein constitute a core proceeding over which this Court has jurisdiction. 28 U.S.C. § 157(b)(2)(A), (B), and (E).

The material facts are undisputed. Juliet Cotton ("Debtor"), James McGarrh, and Hudson incorporated QGCI under the laws of the state of Georgia in 1996, for the purpose of growing, harvesting, and producing rice in the Republic of Ghana. Debtor is a former officer, director and 55 percent shareholder of QGCI and ran its daily operations. Hudson owned 35 percent of the shares and McGarrh held 10 percent.

On June 12, 1997, Debtor acquired title by warranty deed to approximately 61 acres of

farm land in Tunica County, Mississippi (the “Mississippi Property”). It is this real estate that the Trustee proposes to sell.

On or about May 10, 1999, Hudson and McGarrh, both individually and derivatively on behalf of QGCI, brought suit in the Superior Court of Gwinnett County, Georgia, against Debtor based upon alleged misconduct in her role as officer and director of QGCI. *Oscar Hudson and James McGarrh v. Juliet R. Cotton, individually, and as an officer and director of Quality Grain Company, Inc., and Quality Grain Company, Inc., a Georgia Corporation*, Civil Action No. 99-A-3882-6. On February 8, 2001, Hudson and McGarrh caused to be filed a “Notice of Lien on Amount Due to Creditor and Pending Judgment to be Recorded in the Lis Pendens Records” by the Chancery Clerk in Tunica County, Mississippi.

On April 15, 2001, after trial and deliberation, the jury returned a verdict in favor of Hudson and McGarrh, on behalf of QGCI. On May 4, 2001, based upon and incorporating the jury verdict, the Superior Court entered judgment imposing a constructive trust on real property located at 1045 Spyglass Hill Drive, Duluth, Fulton County, Georgia 30097 (the Debtor’s residence); real property located in Tunica, Mississippi; and shares of stock owned by Debtor and Quality Grain Company, Ltd. (Ghana). The judgment also awarded monetary relief in favor of Hudson and McGarrh and against Debtor in the amount of \$6,200,000, plus post-judgment interest at the rate of twelve percent (12%), punitive damages in the amount of \$10,000,000, and attorney’s fees of \$81,200.

Three weeks later, on May 25, 2001, Debtor filed a petition for relief under Chapter 7 of the Bankruptcy Code. Nothing further was filed in the Mississippi records with regard to the litigation, the judgment, or the constructive trust until February 19, 2003, when a notice of filing foreign judgment was entered in the Mississippi lis pendens records.

The Trustee has not challenged the determination of the Gwinnett County Superior Court that Objectors hold equitable title to the Mississippi Property by virtue of the constructive trust recognized in its pre-petition judgment (*i.e.*, whether the Mississippi Property was purchased with funds traceable by the Objectors as constructive trust beneficiaries). For present purposes, therefore, the Court assumes, without deciding, that Objectors have equitable title to the Mississippi Property.

The Trustee obtained a contract to sell the Mississippi Property for \$70,000 to DER Properties and filed her motion to sell the property on August 12, 2003. In opposing the sale, Objectors contend that Debtor holds bare legal title to the Mississippi Property, but that they, as constructive trust beneficiaries, are its equitable owners. Objectors conclude that the Mississippi property is not property of the estate, and that the Trustee thus lacks the authority to sell it, because they, as constructive trust beneficiaries, are its true owners who prevail over the Trustee's claim based on the Debtor's bare legal title. Objectors further argue that the Trustee cannot avoid the constructive trust through the use of § 544's strong arm powers because a hypothetical bona fide purchaser of the Mississippi Property would have had notice of their equitable ownership interest.

The Trustee asserts that the Debtor's recorded legal title to the Mississippi property is superior to an unrecorded equitable interest arising from a constructive trust. The Trustee also contends that the lis pendens filed by the Objectors was defective because the lawsuit it references did not directly involve the property at issue. The Trustee thus concludes that the defective lis pendens did not constitute notice of a lien against Mississippi Property that would defeat a bona fide purchaser under § 544(a)(3).¹

¹The Trustee also contends that the Objectors lack standing to challenge the sale because they are not the "real victims" for which a constructive trust is typically imposed. Based on the Superior Court's judgment, however, Objectors have an equitable ownership interest that gives

Whether Property Subject to a Constructive Trust is Property of the Estate?

A bankruptcy estate consists of all legal or equitable interests of the debtor in property as of the commencement of the case. 11 U.S.C. § 541(a)(1). However, there are exceptions.

Section 541(d) provides that:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of the any equitable interest in such property that the debtor does not hold.

One situation in which there may be a separation of legal title and equitable interest is when a constructive trust is imposed upon property. In such a case, a debtor may hold bare legal title while another entity claims the beneficial interest in the property. A constructive trust is a "trust implied whenever the circumstances are such that the person holding legal title to property, either from fraud or otherwise, cannot enjoy the beneficial interest in the property without violating some established principle of equity." O.C.G.A. § 53-12-93(a). A constructive trust arises, not from the intention of the parties, but in equity to prevent the one holding legal title from retaining title. *United States v. 1419 Mount Alto Road, Rome, Floyd County, Ga.*, 830 F.Supp. 1476, 1481 (N.D. Ga. 1993); *Aetna Life Ins. Co. v. Weeks*, 241 Ga. 169, 172, 244 S.E.2d 46 (1978); *Brown v. Brown*, 209 Ga. 620, 621, 75 S.E.2d 13, 17 (1953). A constructive trust is a remedy, not an independent cause of action, whereby property may be recovered from one who wrongfully holds

them standing.

it. *St. Paul Mercury Ins. Co. v. Meeks*, 270 Ga. 136, 138, 508 S.E.2d 646, 648 (1998). Where the person wrongfully holding funds has invested such funds or has purchased other property, the beneficiary of a constructive trust can follow the money wherever it can be traced. *Adams v. McGehee*, 211 Ga. 498, 86 S.E.2d 525 (1955). It is generally held that a constructive trust arises at the time the equities arise, not at the time a court determines that a constructive trust exists. *United States v. 1490 Mount Alto Road, Rome, Floyd County, Ga.*, 830 F.Supp. 1476, 1481-82 (N.D. Ga. 1993) (noting that although there is no Georgia law directly on point, *Kelly v. Johnson*, 258 Ga. 660, 373 S.E.2d 7 (1988) and *Bateman v. Patterson*, 212 Ga. 284, 285, 92 S.E.2d 8 (1956) support the proposition that constructive trust arises at the time the equities arise); see *In re General Coffee Corp.*, 828 F.2d 699, 703 n.5 (11th Cir. 1999) (quoting A. SCOTT, THE LAW OF TRUSTS § 462.2 (3d ed. 1967) (“[T]here is no foundation whatever for the notion that a constructive trust does not arise until it is decreed by a court. It arises when the duty to make restitution arises, not when that duty is subsequently enforced.”)).

The undisputed facts of this case show that on June 12, 1997, Debtor acquired title to the Mississippi Property by warranty deed and that Hudson and McGarrh, both individually and derivatively on behalf of QGCI, brought suit in May 1999 against Debtor based upon alleged misconduct in her role as officer and director of QGCI in the Superior Court of Gwinnett County, Georgia. After a full trial, the Superior Court of Gwinnett County found a constructive trust to exist on, *inter alia*, the Mississippi Property.

Under the facts of this case, a constructive trust was recognized by the Superior Court of Gwinnett County, as memorialized in its Order, and arose at the time of Debtor's secreting of the funds as alleged by the Objectors in their state court complaint. Therefore, a constructive trust existed prior to the filing of Debtor's bankruptcy petition on May 25, 2001. Although the

constructive trust was not recorded in the Mississippi property records pre-petition, the lack of recording *vis-a-vis* the real property does not impact the pre-petition existence of the constructive trust. In view of the Superior Court's recognition of the constructive trust in favor of the Objectors with regard to the Mississippi Property, that real estate was not property of the estate as of the date of the bankruptcy petition filing.

Whether the Trustee may Exercise her Strong-Arm Powers to Recover the Mississippi Property?

Having determined that property subject to a constructive trust is excluded from the bankruptcy estate, the next issue is whether a bankruptcy trustee may bring the trust assets into the estate using the "strong-arm" powers of § 544(a). Section 544(a)(3) provides that:

(a) 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 -

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

Under this statute, the trustee may avoid transactions and recover real property for the benefit of the estate to the extent that a hypothetical bona fide purchaser of the record title held by the debtor would prevail over another party's interest. This avoidance power permits the trustee to bring into the estate property, such as the assets of an unrecorded constructive trust, that would otherwise be excluded from the estate, if a hypothetical bona fide purchaser's rights would prevail over the unrecorded interest. Under the facts of this case, however, § 544(a)(3) does not permit avoidance because a bona fide purchaser would have had notice of the Objectors' equitable ownership interest

and therefore would not prevail over it.

When there are matters of record, such as a lis pendens, giving constructive notice of a competing interest, the trustee is not a bona fide purchaser and is precluded from using the avoiding powers. *Condren v. Harrison (In re Borison)*, 226 B.R. 779, 787 (Bankr. S.D.N.Y. 1998). A trustee's status as a bona fide purchaser does not supersede state recording statutes; a trustee cannot avoid an interest when the trustee is charged with constructive notice of it under state law. 5 COLLIER ON BANKRUPTCY ¶ 544.08 (Alan N. Resnick & Henry J. Sommer eds., 15TH ed. rev.). Thus, even under the theory that § 544(a) permits a trustee to recover unrecorded property interests otherwise excluded under § 541(d), a trustee cannot avoid an unrecorded interest in land if there is constructive notice of the prior interest that prevails over a bona fide purchaser.

Mississippi law provides for the filing of a notice of suit in the lis pendens records as follows:

When any person shall begin a suit in any court, whether by declaration or bill, or by cross-complaint, to enforce a lien upon, right to, or interest in, any real estate, unless the claim be founded upon an instrument which is recorded, or upon a judgment duly enrolled, in the county in which the real estate is situated, such person shall file with the clerk of the chancery court of each county where the real estate, or any part thereof, is situated, a notice containing the names of all the parties to the suit, a description of the real estate, and a brief statement of the nature of the lien, right or interest sought to be enforced. The clerk shall immediately file and record the notice in the lis pendens record, and note on it, and in the record, the hour and day of filing and recording.

MISS. CODE ANN. § 11-47-3.

A party may not qualify as a bona fide purchaser if she has actual or constructive notice of superior claims. While the law protects a bona fide purchaser for value and without notice, the

Mississippi Supreme Court has recognized that “[a] purchaser of land is charged with notice not only of every statement of fact made in the title, but he is also bound to take notice of and to fully explore and investigate all facts to which his attention may be directed by recitals in said conveyance contained.” *Simmons v. Mississippi Transportation Commission*, 717 So.2d 300, 303 (Miss. 1998) (quoting *Bedford v. Kravis*, 622 So.2d 291, 295 (Miss. 1993)). Similarly, the Mississippi Supreme Court has observed that a purchaser of a judgment against the grantor in a deed of trust who buys the judgment pending a suit to foreclose the deed of trust takes with constructive notice of the pendency of the suit and is chargeable with facts which an inquiry would disclose. *Smith v. Munger*, 47 So. 676, 678 (Miss. 1908) (prior to lis pendens act).

“The legal function of a [l]is [p]endens is to give notice to the world of an alleged claim of a lien or interest in the property.” *Aldridge v. Aldridge*, 527 So.2d 96, 99 (Miss. 1988). A lis pendens “is . . . notice of every fact averred in the pleadings, pertinent to the matter in issue or the relief sought, and of the contents of the exhibits filed and proved.” *Allen v. Poole*, 54 Miss. 323, 1877 WL 4935 at *7 (Miss. 1877). In this case, the Objectors filed a notice of lien in the lis pendens records of Tunica County, Mississippi on February 6, 2001, over three months prior to the filing of the Debtor’s bankruptcy case. A bona fide purchaser examining the property records in Tunica County would have discovered the lis pendens. Inquiry into the lawsuit referenced in the lis pendens would have led to the discovery of the Gwinnett Court judgment, the constructive trust, and the Objectors’ status as beneficiaries thereof. Because a bona fide purchaser is charged with constructive notice under Mississippi law, the Trustee does not have the status of a bona fide purchaser and cannot avoid the equitable interest of Objectors under § 544(a)(3).

The Trustee argues, however, that the lis pendens filed by the Objectors is defective because a lis pendens can only be filed to reference pending litigation which involves the property.

The Trustee argues that in order for the lis pendens to be valid, the lis pendens must be predicated on an action which actually involves the property. She contends that the realty must be actually and directly brought into the litigation by the pleadings in the suit and as to which some relief is sought respecting the particular property.

In *W.H. Hopper and Associates v. Dunaway*, 396 So.2d 43, 44-45 (Miss.1981), the Mississippi Supreme Court recognized that a lis pendens notice cannot establish a lien on property where the property is not involved in the underlying suit for money damages. The Mississippi Supreme Court noted that at common law a lis pendens may not be predicated on an action merely to recover a money judgment unless and until a valid judgment has been secured and made a lien against the property. *Hopper*, 396 So.2d at 45 (quoting 54 C.J.S., *Lis Pendens* § 9). However, the Court also quoted 51 AM.JUR. 2D, *Lis Pendens* § 17 for the following proposition:

Although the extent to which particular property must be “involved in,” or “affected by,” litigation in order to render the doctrine of lis pendens applicable may, of course, be governed by statute, it is clear that some form of identifiable “property” must be directly involved in the litigation, and, further, that the litigation to which the doctrine is sought to be applied must “involve” the particular property to which the doctrine is sought to be applied.

Id.

The undisputed facts show that the Objectors’ state court complaint alleged that Debtor misappropriated, embezzled, and converted funds of QGCI for her personal benefit and that on March 5, 2001, the complaint was amended to add a request for the imposition of a constructive trust on “all funds embezzled or otherwise misappropriated from Quality Grain U.S. . . . for the benefit of Quality Grain U.S., including, any and all property purchased with said funds” (Exhibit 3, Second Amended Complaint). The amended complaint fails to specifically identify the

Mississippi Property by name and location. Moreover, the lis pendens references only a claim for money damages, not the Objectors' claim of an equitable interest in the Mississippi Property. These alleged defects are, however, irrelevant in light of the judgment, entered *prior to the filing of the bankruptcy petition* by the Gwinnett County Superior Court, that affirmatively imposed a constructive trust upon the Mississippi Property. The purpose of a lis pendens is to put the world on notice of a claim of interest in property and serves as notice of every fact averred and proved. *Allen v. Poole*, 54 Miss. 323, 1877 WL 4935 at *7 (Miss. 1877). The filing of the lis pendens by the Objectors placed a prospective purchaser on inquiry notice of their claim; inquiry would have led to discovery not only of the litigation, but also of the existence of a pre-petition judgment imposing a constructive trust on the Mississippi Property on behalf of the Objectors.

In support of her argument, the Trustee points to the findings in *Hudson v. Dobson*, 260 Ga.App. 473, 580 S.E.2d 268 (2003), in which the Georgia Court of Appeals found the Objectors' lis pendens on Debtor's real property in Fulton County, Georgia, defective because the Gwinnett County litigation did not provide a valid basis for the lis pendens. In *Hudson v. Dobson*, the Objectors filed a notice of lis pendens in Fulton County, Georgia, the location of Debtor's residence, on June 8, 2000, after the commencement of the Gwinnett County litigation against Debtor. The lis pendens referenced the pending litigation and stated that claims had been asserted as to the Fulton County property. After the commencement of the lawsuit, but prior to the filing of the lis pendens, Debtor mortgaged the property and executed deeds to secure debt on December 22, 1999, and May 22, 2000. The security deeds were recorded on June 19, 2000. On March 5, 2001, the day before a scheduled foreclosure sale on the residence, the Objectors amended their complaint to seek a constructive trust against the residence. Dobson was the successful bidder at the foreclosure sale and filed a petition in Fulton County to remove the lis pendens and for

declaratory judgment regarding title to the property.

The Georgia Court of Appeals upheld the trial court's ruling that the lis pendens failed to provide legal notice because the underlying complaint did not "involve" the property. The Georgia Court of Appeals found that the Objectors' original suit did not provide a valid basis on which to base a lis pendens because it did not involve the property and alleged tort claims for money damages. The Court found that because the lis pendens was unauthorized, Dobson could not be charged with notice of it. Further, the court found that the Objectors' amended complaint that sought a constructive trust did not revive the invalid lis pendens, but instead created a new lis pendens that did not relate back to the filing of the original complaint.

The facts of *Hudson v. Dobson*, however, are different from the facts before this Court. First, the lis pendens filed in the property records in Mississippi was filed *after* the amendment to the complaint which added the constructive trust claim. Therefore, inquiry into the litigation referenced in the lis pendens by a bona fide purchaser would have revealed the constructive trust claim. Second, unlike the *Dobson* case, a bona fide purchaser here would have discovered a judgment affirmatively imposing a constructive trust, not just pending litigation. Accordingly, the Court does not find the ruling in *Hudson v. Dobson* determinative of this case's outcome.

The Trustee argues that the Objectors' claim to the Mississippi property fails because they did not record their constructive trust pre-petition or do any act to cause their judgment to attach prior to the bankruptcy filing. Under the principles discussed above, recordation of the constructive trust interest is not essential to preservation of the equitable owners' rights against a bona fide purchaser. A constructive trust arises at the time the wrongful or unjust activity occurs and exists from the instant that the funds are unjustly taken. The fact that the judgment was not recorded pre-petition does not negate the fact that the lis pendens put a bona fide purchaser on

notice of the Objectors' claim of interest in the property.

Finally, the Trustee contends that the Objectors' failure to cause notice of the result of their suit to be entered in the property records terminates the lis pendens. This contention is without merit. Section 11-47-11 of the Mississippi Code provides:

Where the proceedings in or as to the suit or levy, notice of which has been entered in the lis pendens record, shall be terminated, whether on the merits or not, the court wherein the same were pending shall direct the clerk who has the record to make such entry therein as it shall prescribe, to give notice of the result of the proceedings and of the . . . real estate; and the clerk shall at once, on presentation thereof, file and record the prescribed entry and note the date of filing and recording on the record.

Although judgment was entered in May 2001 in Gwinnett County, Georgia, the Trustee contends that the Objectors' failure to request entry of the judgment in the Mississippi lis pendens records as of the date of the bankruptcy filing means any person could have purchased the property as a bona fide purchaser. Section 11-47-11 prescribes no consequence for failure to timely cause notice of the results of a suit to be entered. The Trustee has not cited (and the Court has been unable to locate) any Mississippi case interpreting § 11-47-11. The issue, however, is whether a bona fide purchaser had constructive notice of the constructive trust based upon the lis pendens. The Court finds that inquiry into the suit would have revealed not only the nature of the suit, but also the award of a constructive trust by the Gwinnett County Superior Court upon the Mississippi property.

In conclusion, the Trustee has not carried the burden of showing that the Objectors do not own equitable title to the Mississippi Property. Therefore, it is not property of the estate. Because the Court must assume for purposes of the Trustee's motion that Objectors own equitable title, the recordation of the lis pendens referencing the pending litigation and the entry of judgment recognizing the equitable ownership prior to the filing of the petition provided constructive notice to a bona fide purchaser of the equitable interest under Mississippi law. As such, the Trustee's rights as a bona fide purchaser are subject to the Objectors' equitable interest, and the Trustee may not avoid it under § 544(a)(3). Accordingly, it is

ORDERED that the objection of Oscar Hudson and QGCI to the Trustee's motion to sell property is sustained; and it is

FURTHER ORDERED that the Trustee's motion to sell real property located in Tunica County, Mississippi is **DENIED**.

The Clerk is directed to serve copies of this Order on the persons on the attached Distribution List.

At Atlanta, Georgia, this 13 day of February, 2004.



PAUL W. BONAPFEL
UNITED STATES BANKRUPTCY JUDGE

DISTRIBUTION LIST

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