

2005

Volvo Commercial Finance, LLC the Americas, a Delaware limited liability company v. Wells Fargo Bank, N.A., a national banking association : Reply Brief

Utah Court of Appeals

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Recommended Citation

Reply Brief, *Volvo v. Wells Fargo*, No. 20051127 (Utah Court of Appeals, 2005).
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BEFORE THE UTAH COURT OF APPEALS

**VOLVO COMMERCIAL FINANCE,
LLC THE AMERICAS, a Delaware
limited liability company,**

Plaintiff-Appellant,

VS.

**WELLS FARGO BANK, N.A., a
national banking association,**

Defendant-Appellee.

Case No. 20051127-CA

APPELLANT'S REPLY BRIEF

**APPEAL FROM THE THIRD DISTRICT COURT
SALT LAKE COUNTY, STATE OF UTAH,
THE HONORABLE L.A. DEVER
CIVIL NO. 020905207**

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ARGUMENT

A. The trial court erred in holding that when Great Basin transferred funds between accounts, the funds ceased to be proceeds of the Volvo-Financed Vehicles.

Tellingly absent from Wells Fargo's brief is a citation to a *single* case holding that when a debtor shifts funds from one account to another, the funds cease to be proceeds under the lowest intermediate balance rule (LIBR). Wells Fargo also fails to present any reason why a transfer of funds *should* be treated that way, or why Volvo Finance's ability to enforce its security interest in proceeds -- proceeds of vehicles *Volvo Finance* paid for -- should be hampered because Great Basin happened to transfer those proceeds between accounts. Wells Fargo instead relies on statements taken out of context from a couple of cases generally discussing "removal" of funds from accounts, but those cases involved dissipation, not transfers. In addition, Wells Fargo attempts to distinguish the authority supporting Volvo Finance's position because they involved "wrongdoing," but as explained below, Wells Fargo's argument misconstrues the case law. Finally, Wells Fargo insists that the transferred funds ceased to be proceeds because Volvo Finance did not exert enough control over Great Basin, but this argument has nothing to do with tracing and runs counter to the UCC.

The case law is clear, as are the equitable principles behind tracing in general and LIBR in particular: A creditor does not lose his or her claim to funds in a commingled account simply because the debtor changes the funds from one form to another, and this

includes transfers between the debtor's accounts. Nothing in Wells Fargo's brief presents any reason to doubt this conclusion.¹

1. The cases and other authorities Volvo Finance relies on are not distinguishable.

Wells Fargo appears to assert two reasons as to why the Lincoln/Brennan/Oatway² line of cases discussed in Volvo Finance's opening brief supposedly does not control the present case: that (1) the so-called "modern cases" apply LIBR without the "departure" Volvo Finance advocates, and (2) the Lincoln/Brennan/Oatway cases involved "wrong-doing." Wells Fargo is wrong on both accounts.

- a. Modern cases do not reject the principles espoused in *Lincoln*, *Brennan*, and *Oatway*.

First, the so-called "modern cases" Wells Fargo cites have *not* rejected the Lincoln/Brennan/Oatway rule. To the contrary, none of the cases Wells Fargo cites at pages 19-20 of its brief even discussed Lincoln, Brennan, or Oatway, nor did they involve a debtor's transfer of funds from one account or form to another or say anything to suggest

¹ Before delving into the specifics of Wells Fargo's arguments, Volvo Finance must clear up a misstatement in Wells Fargo's brief: That Volvo Finance supposedly does not dispute "that if LIBR's two rules are followed, it cannot trace any of its proceeds into the \$900,000 transfer into the Concentration Account." (Wells Fargo Br. at 16.) This statement is false: It is Volvo Finance's position that if the actual rules of LIBR are followed, Volvo Finance *can* trace its proceeds into the December 29 transfer. Wells Fargo also repeatedly suggests that Volvo Finance seeks an "exception" to LIBR's rules. This, too, is incorrect. Volvo Finance merely asks that LIBR be applied as it always has been. It is Wells Fargo, not Volvo Finance, asking the Court to create an exception to LIBR's rules, which is why Volvo Finance is able to cite several cases supporting its position, while Wells Fargo is unable to cite any on-point cases of its own.

² Lincoln v. Morrison, 90 N.W. 905 (Neb. 1902) (Opening Br. Add. Ex. 7); Brennan v. Tillinghast, 201 F. 609 (6th Cir. 1913) (Opening Br. Add. Ex. 8); In re Oatway, 2 Ch. Div. 356 (1903) (Opening Br. Add. Ex. 9).

that such a transfer should be treated differently than it would under the Lincoln/Brennan/Oatway rule.³ Instead, each of those cases involved the *dissipation* of funds, and as such they have no bearing on the present situation.

Moreover, the Lincoln/Brennan/Oatway rule is perfectly compatible with the LIBR of today, contrary to Wells Fargo's assertion that Lincoln's "general holding" has been rejected because modern cases "hold that merely tracing funds into a general account or showing that assets were increased is not sufficient to establish that the funds have been traced." (See Wells Fargo Br. at 25.) Wells Fargo appears to believe that Lincoln held that a beneficiary need not trace trust funds into a particular account to prevail over a trustee's general creditors, but in fact, Lincoln did no such thing. See Lincoln, 90 N.W. 905. In Lincoln, which involved a city's priority claim in a proceeding to wind up a failed bank, the court discussed earlier cases granting a beneficiary an automatic preference to all of an insolvent trustee's assets. See id. at 906-07. Some of these earlier cases had reasoned that a trustee must restore trust property first, while others reasoned

³ See Meyer v. Norwest Bank Iowa, 112 F.3d 946, 950-52 (8th Cir. 1997) (where proceeds subject to creditor's interest were deposited into account, then account was totally depleted by payments to parties other than the defendant bank, those funds were no longer traceable); Bank of Kansas v. Hutchinson Health Servs., 735 P.2d 256, 259-60 (Kan. App. 1987) (debtor commingled secured proceeds with personal funds already in account, then spent thousands of dollars before bank exercised setoff; remaining balance was held to be traceable proceeds and bank was liable to secured creditor); In re Foster, 275 F.3d 924, 927-28 (10th Cir. 2001) (debtor who ran Ponzi scheme transferred funds to one defrauded investor immediately prior to bankruptcy court's entry of order for relief; trustee sought to avoid transfers; court held that favored investor could not use LIBR to claim special interest in funds where account was largely comprised of funds taken from other defrauded investors); In re Edison Bros., 268 B.R. 409, 413-14 (Bankr. D. Del. 2001) (where account was fully dissipated after deposit of secured proceeds, claimant could not trace funds).

that a trustee's use of the trust funds to pay his debts ends up benefiting the trustee's general estate, so that the beneficiary should be compensated out of the entire estate. Id. at 907. The court, however, squarely *rejected* those cases: "We are not able to agree to the rule just stated in any of the forms which it has assumed." Id.

Instead, Lincoln expressly affirmed the two basic premises of LIBR. The court explained, "Whatever moneys were drawn out of that [commingled] fund and dissipated are presumed to be those of the bank. The portion that remains, in whatever form, is taken to be and represent the trust fund, and to be liable to be followed and claimed as such by the city." Id. at 908. This is the first presumption of LIBR and has been followed by the Utah Supreme Court. See Tooele County Bd. of Educ. v. Hadlock, 79 Utah 478, 11 P.2d 320, 325 (1932) ("The law presumes that trust funds were not appropriated and that a balance of cash in the hands of the depository is the trust funds."). Lincoln also states that "if the whole of the cash on hand into which the city's money entered, or a greater portion thereof than that representing the bank's own money, was used in paying off other depositors or in running expenses, the city is not entitled to a preference over general creditors for the amount of its money so lost." Lincoln, 90 N.W. at 908. This is the second presumption of LIBR and is also consistent with Utah law. See Hadlock, 11 P.2d at 325.⁴ There is simply no basis for Wells Fargo's suggestion that the principles applied in Lincoln have fallen out of favor.⁵

⁴ As stated in Hadlock, 11 P.2d at 325 (emphasis added): "[I]f, at any time during the currency of the commingled account, the amounts drawn out leave a balance less than the amount of the trust money, the trust money must be regarded as dissipated to that extent, leaving the trust to be impressed only on the smallest balance that appears to have

- b. The *Lincoln/Brennan/Oatway* cases cannot be distinguished on the basis of "wrongdoing."

Wells Fargo's attempt to distinguish Volvo Finance's cases by claiming that they involved "conscious wrongdoing on the part of the holder of the funds" is even less compelling. (See Wells Fargo Br. at 21.) Nothing in the holdings or reasoning of the cases suggests that their application of tracing principles was based on the desire to punish wrongdoing. Moreover, given the dynamics of these cases, it defies logic to suggest that the results were driven by such a motive.

Wells Fargo's entire argument is based on a fundamental misreading of the Lincoln/Brennan/Oatway cases. Wells Fargo contends that the Lincoln/Brennan/Oatway cases no longer apply because modern cases "most often deal with two innocent parties, as here." (Wells Fargo Br. at 20.) Even if Wells Fargo's claim of innocence were true,⁶

been *on hand* at any time during such period. The sums subsequently added to the account from other sources cannot be attributed to the trust money."

⁵ Wells Fargo is simply wrong to assert that the Lincoln court failed to do a LIBR analysis; to the contrary, the very first paragraph of the opinion carefully details what balance was in the failed bank's account after the city deposited its funds, what happened to the funds in the account after the city's deposit, and what funds were in the account when the bank failed. See Lincoln, 90 N.W. at 906.

Similarly, Wells Fargo misses the point when it asserts that Lincoln's approach was rejected in the "modern" case of In re Winkle, 128 B.R. 529, 535 (S.D. Ohio 1991). The reasoning and holding of Lincoln are perfectly consistent with Winkle's statement that funds must be traceable to "identifiable trust assets, and not merely to general funds of the debtor." Id.

⁶ Wells Fargo's claim to "innocence," of course, is suspect: Regardless of whether Wells Fargo acted with willful malfeasance, the record shows that Wells Fargo chose to advance money to Great Basin knowing that Great Basin would likely be repaying those advances with proceeds of truck sales subject to Volvo Finance's security interest. (See R. 604, 694, 1004-05, 1106-07.) The record also shows that Wells Fargo did not investigate Great Basin's financial condition or the status of Great Basin's accounts with Volvo Finance or any of the 35 *other* creditors disclosed by the UCC-1 records. (See id.)

that would not distinguish the Lincoln/Brennan/Oatway cases, because each of those cases ultimately dealt with a dispute between two "innocent" parties.

The Lincoln/Brennan/Oatway cases (like most creditor-vs.-creditor priority disputes) all followed the same basic pattern. Three actors were involved: a debtor, a special creditor (secured creditor or trust beneficiary), and a general creditor (or a set of general creditors). In each case, the debtor was defunct, with assets insufficient to satisfy all creditors (otherwise priority would have been irrelevant). Thus, in each case a court had to decide between awarding the special creditor priority to the debtor's limited assets or leaving the special creditor to share in the remnants of the debtor's estate. As Wells Fargo points out, the special creditor and the general creditors are usually both "innocent parties"; consequently, no matter which way the court ruled, the decision would prejudice an innocent party.

A comparison of Wells Fargo's brief and the Brennan case highlights some of the problems with Wells Fargo's "wrongdoing" theory. See Brennan, 201 F. 609. In Brennan, the Ironwood Bank had failed and a receiver was appointed. Id. at 611. Wells Fargo suggests that the dispute was between the depositor and the bank, and that the court held that the plaintiff "should prevail over the conscious wrongdoer, Ironwood" (Wells Fargo Br. at 22), but this is factually incorrect. The dispute was actually between the plaintiff, whose stock the bank had wrongfully sold, i.e., the special creditor, and a receiver appointed to represent the general creditors. See 201 F. at 611-12. Moreover, the Brennan court said nothing to suggest that someone's wrongdoing affected how the tracing rules were applied. Finally, there is no basis to ascribe such a motive to the court, since the

parties that lost, i.e., the general creditors, *had not engaged in any wrongdoing*. The bank itself may have engaged in wrongdoing by selling the plaintiff's stock, but the bank, being defunct, had no stake in the outcome. (Wells Fargo's statement that "the court refused to apply the neutral rules of LIBR to the benefit of the wrongdoer" (Wells Fargo Br. at 22) is also wrong; had the court ruled the other way, the beneficiary of that decision would have been the general creditors, not the bank.)

Lincoln, 90 N.W. 905, is very similar to Brennan. The dispute was between the city (special creditor), whose agent had made an unauthorized loan to the bank, and a receiver acting for the failed bank's general creditors. Id. at 906. As in Brennan, the bank was defunct, the court did not say that its application of tracing principles was motivated by the wrongdoing of one of the parties, and the losing general creditors had not engaged in any wrongdoing.

Finally, in Oatway, the "wrongdoer," i.e., the trustee who had breached the trust, had *died*. See 2 Ch. Div. at 356-57. Obviously, the court was not going to be able to punish him. Oatway was a creditor's action for administration of his estate, and the court had to decide between competing claims by the beneficiaries of a trust the decedent had breached, the special creditors, and the decedent's general creditors and/or heirs. Id. As with the other cases, the court ruled in favor of the special creditor even though there was no suggestion that the decedent's creditors or heirs had done anything wrong. Thus, nothing in the reasoning or the result of these cases supports Wells Fargo's theory that the

tracing rules were applied in a unique way because of a concern about "wrongdoing."⁷

2. Wells Fargo's claim that Volvo Finance allegedly failed to protect its collateral does not justify the trial court's departure from the longstanding rules of LIBR.

The Court should reject Wells Fargo's argument that it would be improper to trace funds according to the Lincoln/Brennan/Oatway principles because Wells Fargo was merely an innocent transferee, while Volvo Finance supposedly did not do enough to protect its collateral. This argument fails for three reasons: First, the argument has nothing to do with tracing, but instead involves substantive issues of priority. Second, the UCC relieves Volvo Finance of any obligation to police Great Basin's use of collateral. Third, Wells Fargo has not established that Volvo Finance failed to use proper diligence in its dealings with Great Basin.

- a. Even if Wells Fargo's argument had merit, the argument would not affect the application of LIBR.

First, Wells Fargo's argument is misplaced because it conflates the issue of *tracing* with the issue of *priority*. Wells Fargo has presented no reason why tracing rules should be applied differently depending on a court's determination as to which creditor was more or less culpable for a debtor's default. Wells Fargo's cases do not suggest that the tracing

⁷ To the extent the Lincoln/Brennan/Oatway cases involved "wrongdoing," they involved wrongdoing by the *debtor*. And here, *Great Basin* clearly engaged in wrongdoing. Violating its agreements with Volvo Finance, agreements that made Great Basin a trustee over sales proceeds for Volvo Finance's benefit (see R. 541), Great Basin failed to immediately remit to Volvo Finance the balance owed on each truck that Great Basin sold. Instead, Great Basin kept the funds for its own use. Great Basin thus engaged in the same wrongdoing as did the debtor/trustees in Lincoln, Brennan, and Oatway. *Wells Fargo* may or may not have engaged in deliberate malfeasance, but as explained in the text, neither did the general creditors in the Lincoln/Brennan/Oatway cases.

rules should be applied one way if the general creditor is more at fault than the special creditor, but another way if the special creditor is more at fault. Indeed, it would be utter chaos if the tracing rules depended on a court's assessment of the parties' efforts in each particular case. Adopting such an approach would frustrate the UCC's purpose of achieving uniformity and reliability in commercial transactions.⁸

Wells Fargo sought summary judgment on the ground that the December 21-22 transfer of \$2 million should be deemed to have included non-proceeds first, leaving no proceeds to be transferred back to the Concentration Account on December 29. Wells Fargo's motion was based on the tracing analysis prepared by its expert, Derk Rasmussen. This analysis purported to apply the rules of LIBR as Mr. Rasmussen contended they should be applied; none of the figures on his analysis, or on the analysis prepared by Volvo Finance's expert David Judd, depended on who was more "at fault."

Under the positions presented in this case, the \$2 million transferred on December 21-22 either included \$1,791,919 in proceeds or \$1,066,584 in proceeds. (See generally Volvo Finance Opening Br. at 20-25.) Depending on the answer to that question, the amount of proceeds in the First Security Account on December 29 was either \$3,707,516 or \$2,982,181, and the transfer back to the Concentration Account included either

⁸ Wells Fargo has asserted in another context that the Lincoln/Brennan/Oatway rule should not be followed here because it might be difficult to distinguish between a transfer "intended for dissipation" from a "regular" transfer. (See Wells Fargo Br. at 21 n.10.) Wells Fargo, once again, is either missing, or misstating, the point. The rule as it has existed for a century has nothing to do with the debtor's intent, but with whether the debtor maintains possession of the funds. But even if intent were an issue, the difficulties posed to the tracing regime by determining intent would pale in comparison to the difficulties posed by determining which of two creditors is more responsible for losses caused by the debtor.

\$693,132 in proceeds or \$0 in proceeds. (See id. at 24.) There is no reason why the answer to these questions should depend on whether Volvo Finance took adequate steps to protect its collateral or whether Wells Fargo should have investigated Great Basin's financial condition before making an \$800,000+ unsecured loan. If in fact Wells Fargo received proceeds in which Volvo Finance had a security interest (which Wells Fargo did, under Lincoln/Brennan/Oatway), then the issue of whether Wells Fargo or Volvo Finance has a higher claim to those proceeds is a matter of priority law under the UCC.

b. Volvo Finance had no obligation to police Great Basin's use of the trucks or the proceeds.

The Utah Code clearly states that a creditor has no obligation to restrict a debtor's use of collateral:

A security interest is not invalid or fraudulent against creditors *by reason of liberty in the debtor to use, commingle, or dispose of all or part of the collateral . . . or to use, commingle or dispose of proceeds*, or by reason of the failure of the secured party to require the debtor to account for proceeds or replace collateral.

Utah Code Ann. § 70A-9-205 (2000) (emphasis added). As Volvo Finance explained in its opening brief, "[t]he purpose of the provision is to relieve creditors from the age-old requirement of policing collateral in the hands of a debtor." Insley Mfg. Corp. v. Draper Bank & Trust, 717 P.2d 1346 (Utah 1986). Thus, a secured creditor may refrain from "policing" collateral, and may grant the debtor control over secured proceeds without weakening its security interest. Miracle Feeds v. Attica Dairy Farm, 385 N.W.2d 208, 210 (Wis. App. 1986). See also J.R. Simplot Co. v. Sales King Int'l, 2000 UT 92, ¶¶ 43-45, 17 P.3d 1100 (creditor has no duty to require periodic payments). Volvo Finance had

no duty to either "monitor" Great Basin's use of proceeds or to require Great Basin to segregate those proceeds from other funds.

- c. Volvo Finance acted reasonably and prudently; at the very least, even if the issue were relevant, fact questions would render summary judgment inappropriate.

Finally, there is *no* basis for Wells Fargo's suggestion that Volvo Finance failed to take proper steps to protect its collateral. As Wells Fargo's brief acknowledges, Volvo Finance sent a notice of default to Great Basin on December 8, 2000, demanding payment of all sums owed to Volvo Finance. (See Wells Fargo Br. at 7.) On December 20, Volvo Finance notified Great Basin that Volvo Finance was suspending Great Basin's lines of credit and notifying all manufacturers of that step, and that all future transactions would require payment by certified check or the equivalent before Volvo Finance would release any certificates of origin or titles for Great Basin's trucks. (Id.; R. 1036, 1075.) On December 21 and 22, Volvo Finance sent written notices to all known account debtors of Great Basin who had bought Volvo-Financed Vehicles, directing them to make future payments directly to Volvo Finance. (Wells Fargo Br. at 7.) Volvo Finance also sent notice to Zions Bank asking Zions to segregate sales proceeds and hold them for Volvo Finance's benefit. (Id.)⁹

⁹ Wells Fargo's assertion that Volvo Finance did not suspend Great Basin's line of credit (Wells Fargo Br. at 29) is unsupported by the record. Further, Wells Fargo's statement that Volvo Finance did not ask Great Basin to segregate funds is misleading; the Financing Agreements required Great Basin to immediately remit sales proceeds to Volvo Finance (R. 540), so there would be no need for "segregation." Wells Fargo's statement that Volvo Finance did not require direct payment from Great Basin's buyers is also misleading. In late October 2000, Volvo Finance took possession of all Manufacturer's Statements of Origin ("MSOs") and vehicle titles for all collateral, and notified

Wells Fargo argues that Volvo Finance did not notify Wells Fargo about its problems with Great Basin, and instead "allowed" Great Basin to deposit sales proceeds into the Concentration Account (Wells Fargo Br. at 29), but Wells Fargo fails to tell the Court that *Volvo Finance was unaware that Great Basin had any accounts with Wells Fargo*. (R. 1123.) Volvo Finance was thus at a serious disadvantage relative to Wells Fargo: Wells Fargo knew about Volvo Finance, but Volvo Finance did not know about Wells Fargo.¹⁰

The only thing Volvo Finance did not do was physically repossess its inventory from all the Great Basin dealerships prior to the bankruptcy filing. But the record contains no evidence suggesting that the circumstances at the time justified taking such a drastic step, or that taking such action was even commercially reasonable.¹¹

Finally, even if the issue of Volvo Finance's alleged negligence were relevant to the tracing issue, the trial court's judgment would have to be reversed, because Wells Fargo has not established as a matter of law that Volvo Finance was negligent. Once

Volvo Trucks North America to send Volvo Finance all MSOs on any additional vehicles bound for Great Basin. (R. 1033.) Volvo Finance then required Great Basin to furnish detailed information concerning each truck sale before Volvo Finance would release the MSO and title to Great Basin's customers. (*Id.*) There was simply no other way for Volvo Finance to prevent Great Basin from selling trucks to customers without Volvo Finance's knowledge, short of taking physical possession of the trucks.

¹⁰ Wells Fargo suggests that Volvo Finance "cannot claim that it was not aware of Great Basin's banking relationship with Wells Fargo" because fine print on some of Great Basin's checks said that the checks were drawn on Wachovia Bank N.A. "in cooperation with & Payable if Desired at Wells Fargo Bank, N.A." (Wells Fargo Br. at 6 n.4.) This is absurd. There is no basis to conclude that this reference on fine print on checks received in Volvo Finance's receivables department would give notice to the entire company that Great Basin was depositing sales proceeds into accounts with Wells Fargo.

¹¹ In November 2000, Volvo Finance had contacted Zions Bank and was told that Great Basin's loans and line of credit with Zions were in good standing. (R. 1034.)

again, the record contains no evidence as to what actions would or would not have been commercially reasonable at the time; Wells Fargo merely asks the Court to speculate that it was unreasonable for Volvo Finance to allow Great Basin to maintain possession of its collateral. Since this is an appeal from summary judgment granted to Wells Fargo, Wells Fargo's failure to establish a right to judgment as a matter of law means that the summary judgment cannot be upheld on this basis.

3. Great Basin did not "dissipate" the funds by transferring them to the Concentration Account where Wells Fargo seized them.

Wells Fargo appears to contend that LIBR should not be applied in accordance with the Lincoln/Brennan/Oatway cases because the funds were no longer in possession of the debtor or are no longer "in existence." (See Wells Fargo Br. at 30-31.) It is difficult to understand precisely what Wells Fargo is claiming. Wells Fargo may be asserting that Volvo Finance's security interest was defeated by Wells Fargo's seizure of the funds from the Concentration Account. (See, e.g., Wells Fargo Br. at 31 n.18 (suggesting that Lincoln/Brennan/Oatway cases are distinguishable because the funds were still in the trustee's possession).) If Wells Fargo were correct that a bank's seizure or receipt of proceeds "dissipates" the funds under LIBR, however, then no creditor could ever bring a conversion claim in such a case. This is obviously not the case, since the law is clear that even in the "modern" context, a secured creditor can use LIBR to pursue a conversion claim against a junior creditor that has received proceeds. Indeed, Wells Fargo cited at least one such case. See Bank of Kansas v. Hutchinson, 735 P.2d 256 (Kan. App. 1987).

In Bank of Kansas, the debtor commingled secured proceeds and its own funds in its general checking account. See id. at 257-58. Over the next two weeks, most of the account was dissipated; the bank then declared itself insecure on other loans owed by the debtor and set off the remaining balance of the account. The court concluded that under LIBR, the funds remaining in the debtor's account at the time of setoff were proceeds subject to the secured creditor's interest, and the setting off bank was liable to pay the account balance to the secured creditor. Id. at 259-61. In Bank of Kansas, as in the present case, the funds had been taken by the debtor's bank before the secured creditor brought its claim, but the secured creditor prevailed nonetheless. See also C & H Farm Serv. v. Farmers Sav. Bank, 449 N.W.2d 866, 877 (Iowa 1989) (holding that LIBR tracing principles apply notwithstanding argument that bank's seizure of funds to repay overdraft balance rendered proceeds unidentifiable).

Revised Article 9, in effect in Utah since 2001, expressly recognizes that a secured creditor may use LIBR's tracing principles to establish a claim to proceeds received by another. Section 9-315 states that commingled proceeds are "identifiable" if the secured party "identifies the *proceeds by a method of tracing, including application of equitable principles.*" Utah Code Ann. § 70A-9a-315(2)(b) (emphasis added) The Official Comment explains that this section "permits the use of whatever methods of tracing other law permits with respect to the type of property involved. *Among the 'equitable principles' whose use other law may permit is the 'lowest intermediate balance rule.'*" *See Restatement (2d) Trusts § 202.*" Id., cmt. 3 (emphasis added). Section 202 of the Restatement of Trusts, as cited in Volvo Finance's opening brief, incorporates the Lincoln/Brennan/Oat-

way rule. See Restatement (2d) Trusts § 202 (1959) (Add. Ex. 11 hereto), especially cmt. i;¹² see also *id.* cmts. h, j, l. Revised Article 9 is obviously "modern" authority, and it clearly supports the use of LIBR, including the Lincoln/Brennan/Oatway rule, to support a senior creditor's claim.

This is a conversion and unjust enrichment case: Volvo Finance contends that when Great Basin transferred the \$900,000 to the Concentration Account on December 29, some of those funds were subject to Volvo Finance's security interest. When Wells Fargo seized those funds, Wells Fargo exercised dominion and control over them in a manner inconsistent with Volvo Finance's interest. Therefore, Wells Fargo committed a conversion and was unjustly enriched. These principles operate the same regardless of whether the debtor deposits proceeds directly into an account immediately before they are seized, as in Insley; whether the debtor deposits proceeds into an account and they remain for two weeks, as in Bank of Kansas; or whether the debtor deposits them into the account and transfers them to another account and back, as in the present case.

Regarding whether the funds are "no longer in existence," the funds certainly were in existence when Wells Fargo seized them. If anyone dissipated them, it was Wells Fargo. Cf. C & H, 449 N.W.2d at 877 ("The proceeds were not made unidentifiable by

¹² The pertinent portion of comment i states as follows (with emphasis added): "The beneficiary's lien is not restricted to any part of the deposit but extends to the whole deposit and can be enforced against any part of the funds remaining on deposit *and against any funds which are withdrawn, so long as they can be traced. So also, there is no inference that the trustee withdraws his own funds first. If the funds withdrawn are preserved or can be traced, the beneficiary can enforce an equitable lien upon them or their product, even though the funds remaining on deposit are subsequently dissipated.*"

the bank's setoff; the bank now holds them for its own benefit."). The issue raised by Volvo Finance's claims is whether Wells Fargo exercised dominion and control over funds in which Volvo Finance had an interest on December 29, 2000, not what Wells Fargo has done with those funds since then.¹³

On the other hand, Wells Fargo may be contending that the funds were dissipated because the NSF items that Wells Fargo paid were used for Great Basin's various business expenses. If this is Wells Fargo's argument, then Wells Fargo is misunderstanding the events of December 27-29. As explained in more detail in Volvo Finance's opening brief (pp. 8-9), it was Wells Fargo, not Great Basin, that paid the NSF items on December 27 and 28, advancing approximately \$828,000 of Wells Fargo's own funds. Then, on December 29, Great Basin transferred the \$900,000 into the Concentration Account, but instead of making that amount available for Great Basin's use, Wells Fargo set off the amount of the deposit against the amount Great Basin owed for the advances. Wells Fargo's suggestion that Great Basin dissipated the funds to cover business expenses is wrong: Wells Fargo paid the items at issue on December 27 and 28, and seized the

¹³ The Court can also reject Wells Fargo's contention that it would be unfair to apply LIBR according to the Lincoln/Brennan/Oatway cases, because some of the items Wells Fargo paid went to Volvo Trucks, whom Wells Fargo describes as a "sister company." (Wells Fargo Br. at 29-30.) Wells Fargo presented *no* evidence below that Volvo Trucks North America was a "sister company" of Volvo Finance. To the contrary, Volvo Finance is a completely distinct company from Volvo Trucks North America (VTNA). (See R. 1380, ¶ 6.) Volvo Finance provides financing to dealers and customers; VTNA sells trucks, parts, warranties, and other related products. Volvo Finance and VTNA have separate management. VTNA had no security interest in the vehicles that Volvo Finance financed for Great Basin. A dealer's obligations to VTNA would be entirely separate from its obligations to Volvo Finance. (*Id.*) Moreover, any payments Great Basin made to VTNA are unrelated to the proceeds from the 53 Volvo-Financed Vehicles Great Basin transferred into its Wells Fargo accounts. (See *id.*)

funds, including Volvo Finance's proceeds, from the Concentration Account two days later.

4. The *Lincoln/Brennan/Oatway* rule is the only one faithful to the principles and purposes of LIBR.

As shown in the preceding sections, the law is clear that under the cases, Restatements, and other authorities, a debtor's transfer of funds from one account to another, or from one form to another, does not defeat a creditor's claim to those funds. Wells Fargo's arguments as to why that authority does not apply are simply unpersuasive. Moreover, Wells Fargo has not presented any reason why the Lincoln/Brennan/Oatway rule should be disregarded in this case, i.e., why a debtor's transfer of funds between accounts *should* be deemed to include non-proceeds first.

LIBR is based on the presumption that the trustee acts honestly and thus keeps the beneficiary's funds inviolate to the greatest extent possible. See Hadlock, 11 P.2d at 325. Here, at all pertinent times, Great Basin always kept a greater amount of funds in its possession than the amount Volvo Finance claims as proceeds.¹⁴ (See Tracing Analysis, Opening Br. Add. Ex. 2.) Thus, under the reasoning of Hadlock, there is no reason to think that the proceeds balance was diminished when Great Basin transferred funds between accounts. Upholding the trial court's application of LIBR would be inconsistent with the basis of LIBR itself, would defeat the purposes of LIBR, and would conflict with Hadlock, the Lincoln/Brennan/Oatway cases, and the other authorities Volvo Finance has

¹⁴ From December 7 through 21, the Concentration Account balance always equaled or exceeded the proceeds balance. From December 22 until December 29, the balance transferred to and retained in the First Security Account exceeded the proceeds balance.

discussed. Volvo Finance respectfully submits that the Court should not disregard such authority without a compelling reason, and Wells Fargo has failed to present one. The Court should therefore reverse the trial court's ruling that Great Basin's transfer of \$900,000 on December 29, 2000, did not include any proceeds generated by the sale of the Volvo-Financed Vehicles.

B. Revised Article 9 does not retroactively relieve Wells Fargo from liability for a conversion that took place before the Revised Article became effective.

The Court should disregard Wells Fargo's half-hearted request to uphold the trial court's judgment on the ground that this case is controlled by Revised Article 9. As Volvo Finance explained in its opening brief, the Utah Code expressly states that "if the relative priorities of the claims were established before this act takes effect, former Chapter 9 determines priority." Utah Code Ann. § 70A-9a-709(1). The purpose of this statute was to ensure that the Revised Article did not affect conflicting claims to the same collateral. See Interbusiness Bank v. First Nat'l Bank of Mifflintown, 318 F. Supp. 2d 230, 238 (M.D. Pa. 2004) (emphasis added) ("This section functions as a grandfather clause, *protecting interests that enjoyed priority under former Article 9 but would lose that status under the revised provisions.*")¹⁵

¹⁵ See also In re New Haven Foundry, 285 B.R. 646, 649 (Bankr. E. D. Mich. 2002) (former Article 9 governed a dispute between a creditor claiming setoff rights that accrued in 1999 and a creditor who obtained a security interest in April 2001: "Thus, the relative priorities were established before the July 1, 2001, effective date of Revised Article 9 in Michigan, and therefore the Revised Article 9 does not apply."); Consolidated Nutrition v. IBP, Inc., 669 N.W.2d 126, 132 (S.D. 2003) (where creditor claimed funds as setoff in April 2001, dispute between that creditor and financier with 1998 financing statement was decided under former Article 9); In re Chorney, 277 B.R. 477, 486 (Bankr. W.D.N.Y. 2002) (priority dispute between creditor's rights based on

Wells Fargo's only response to this is to deny that this case involves a priority dispute because Wells Fargo "does not claim a priority to the funds in question." (Wells Fargo Br. at 36.) First, this is flatly untrue; at least three of the affirmative defenses in Wells Fargo's Amended Answer assert that Wells Fargo had a "superior interest in the funds" at issue. (R. 76 (Defenses 3-5).) Second, Wells Fargo is being too cute. Volvo Finance asserts that Wells Fargo is liable for conversion because Volvo Finance had a greater right to the funds than Wells Fargo did. Wells Fargo disputes this. Thus, to resolve the case, the Court will have to determine the "relative priorities" of Volvo Finance and Wells Fargo in those funds. And because the parties' relative priorities were established on December 29, 2000, six months before the Revised Article took effect, then "former Chapter 9 determines priority."¹⁶ Utah Code Ann. § 70A-9a-709(1).

Once again, Wells Fargo's position is illogical. As explained in Volvo Finance's opening brief, the Revised Article gave creditors until July 2001 to take the extra steps required to perfect interests in proceeds held in a checking account. Therefore, it makes

November 1999 financing statement and bankruptcy trustee's rights based on October 2000 filing governed by former Article 9); Fifth Third Bank v. Comark, 794 N.E.2d 433, 438 (Ind. App. 2003) (dispute between creditors, both relying on financing statements filed in 2000, governed by former Article 9).

¹⁶ Wells Fargo is wrong when it attempts to distinguish Interbusiness Bank. The facts in Interbusiness Bank were very similar to the facts here: The defendant seized funds from a debtor that owed it money, and the plaintiff asserted that the defendant's actions interfered with the plaintiff's superior perfected security interest. Indeed, the defendant in Interbusiness Bank actually seized the debtor's funds *after* July 1, 2001, yet the court held that the former Article applied. See 318 F. Supp. 2d at 238-39. The defendant in Interbusiness Bank based its claim on a perfected security interest rather than as an innocent transferee, but it would be absurd to conclude that whether the statute applies retroactively depends on the particular justification a defendant gives for its seizure of the funds. See also Consolidated Nutrition, 669 N.W.2d at 132 (plaintiff sued to recover proceeds paid to other creditor).

no sense for the Revised Article to apply to events that took place in December 2000. It also makes no sense to say that Wells Fargo's actions constituted a conversion, for which Wells Fargo was liable from December 29, 2000, through June 30, 2001, but that Wells Fargo was relieved of this liability on July 1, 2001. Indeed, one must question Wells Fargo's good faith in asserting that the case is governed by the Revised Article, since Wells Fargo's own Amended Answer cites the Former Article as authority for three of its affirmative defenses yet does not even *mention* the Revised Article. (R. 78-79 (Defenses 14-16).) There is no basis to conclude that the Revised Article applies, and as such it would be inappropriate to uphold the trial court's judgment based on the Revised Article.

C. Wells Fargo has not established that the "ordinary course" defense bars Volvo Finance's claim as a matter of law.

1. As a matter of law, Wells Fargo cannot rely on the purported defense.

a. *Insley* precludes the defense in a case like this.

As it did before the trial court, Wells Fargo asks the Court to hold that because Wells Fargo did not have actual knowledge of Great Basin's default to Volvo Finance, Wells Fargo cannot be liable for conversion under the "ordinary course" defense of Comment 2(c) to Former UCC § 9-306. There is simply no way, however, for this Court to apply the "ordinary course" defense and remain faithful to *Insley*. As explained in Volvo Finance's opening brief, the facts of this case are functionally *identical* to those of *Insley*. Further, the reasoning and policy decisions expressed in the out-of-state cases Wells Fargo relies on are fundamentally inconsistent with the reasoning and policy decisions

expressed in Insley. As the Court is bound by Insley, the Court must reject Wells Fargo's attempt to avoid liability under the "ordinary course" defense.

Neither J.I. Case Credit Corp. v. First National Bank, 991 F.2d 1272 (7th Cir. 1993), nor Textron Financial Corp. v. Firststar Bank Wisconsin, 579 N.W.2d 48 (Wis. App. 1998), supports the defense here. Notably, neither court actually addressed whether Comment 2(c) actually furnishes a defense against a conversion claim; instead, the point was *conceded* in both cases. See J.I. Case, 991 F.2d at 1276 ("Both the Bank and Case agree, based on language in *Citizens Nat'l Bank*, that Indiana has recognized Comment 2(c) as an exception to the Code's general priority rules."); Textron, 579 N.W.2d at 51 ("[I]n light of Textron's failure to raise this issue, for purposes of this case we will assume that the comment alone can support an exception to the Code's general priority rules."). Thus, Wells Fargo's reliance on these cases begs the question, which is whether Comment 2(c) provides a defense to a bank who seizes a creditor's proceeds.

Further, both cases are factually distinguishable, in that neither case involved a bank's seizure of funds from a debtor's account to repay overdraft advances. In J.I. Case, the debtor financed a used car business through the bank and had "several other loans" from the bank, and the debtor paid the bank by checks drawn on his business checking account. 991 F.2d at 1273-74. The Seventh Circuit expressly relied on this fact in holding that the ordinary course defense applied: "Unlike the bank in *Citizens National Bank*, which unilaterally took deposited funds by way of set-offs, the Bank here received

checks drawn on Humphrey's business account." Id. at 1276.¹⁷ In Textron, the debtor had pre-existing loans from the bank secured by all the debtor's assets except those specifically pledged elsewhere, and the bank "recovered" funds from the debtor's account to be applied to one of the delinquent loans. 579 N.W.2d at 584-85.¹⁸

More importantly, however, J.I. Case and Textron are based on premises that flatly contradict Insley. Both cases grant a bank an absolute right to keep proceeds received from a debtor, even in the face of a superior perfected security interest, if the bank did not have actual knowledge that the funds were subject to the creditor's interest, or at least if the bank was not "reckless." Under these cases, a UCC-1 filing is not sufficient to protect a creditor's security interest in proceeds against a bank that seizes the proceeds from the debtor's account. This reasoning, however, flies in the face of Insley's holding that "[a] secured party *should be able to rely on his compliance with the Code's requirements for perfection and his search of the record as against an unrecorded interest of a setting-off bank.*" Id. at 1346 (emphasis added).¹⁹

¹⁷ Citizens National Bank, discussed later in the text, was one of the key cases on which Insley relied. See Insley, 717 P.2d at 1346 (citing Citizens Nat'l Bank v. Mid-States Dev. Co., 380 N.E.2d 1243, 1249 (Ind. App. 1978)).

¹⁸ In footnote 23, Wells Fargo cites two additional "ordinary course" cases. Just like the cases discussed in the text, neither case involved a bank's seizure of funds from a deposit account to repay overdraft advances. See ITT Comm. Fin. Corp. v. Bank of the West, 166 F.3d 295 (5th Cir. 1999) (debtor made payments by check on pre-existing loans secured by debtor's collateral); Ford Motor Credit Co. v. State of New York, 641 N.Y.S.2d 742 (App. Div. 1996) (debtor made payments by check to State for pre-existing sales tax liability).

¹⁹ Wells Fargo incorrectly suggests that the Utah Supreme Court's subsequent discussion in Simplot leaves the issue open. See J.R. Simplot, 2000 UT 92. In fact, Simplot further demonstrates the inherent conflict between Insley and the ordinary course defense. In Simplot, the court rejected the ordinary course defense because the situation

Recognizing this problem, Wells Fargo attempts to distinguish Insley by denying that the present situation involves a "setoff." Any attempt to distinguish Insley is futile, however. In Insley, the bank advanced funds to cover the debtor's overdrafts, the debtor deposited proceeds into the account, and the bank subtracted the amount of the advance from the deposited amount in determining what funds the debtor had available. Here, Wells Fargo advanced funds to cover Great Basin's overdrafts, Great Basin deposited \$900,000 into the Concentration Account, and Wells Fargo subtracted the amount of the advance from the deposited amount in determining what funds Great Basin had available. Wells Fargo's actions were no different from the bank's in Insley.

Wells Fargo cannot legitimately deny that it exercised a setoff. Indeed, before the trial court, Wells Fargo denied liability on the ground that Wells Fargo had both a "common law right of setoff" and a "contractual right of setoff." (See R. 76 (Defenses 4-5).) Further, Wells Fargo's actions were the very *epitome* of a setoff.

A "setoff" is what happens when one party uses a debt owed to him to "cancel out" all or part of a debt he owes to another. See In re Myers, 362 F.3d 667, 672 (10th Cir. 2004) (internal quotation and citation omitted) ("The right of setoff allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the absurdity of making A pay B when B owes A."). When a customer deposits funds, the bank essentially owes a debt to the customer for the amount of that deposit; this "credit" is what obligates the bank to allow withdrawals or pay checks presented for payment.

"closely resemble[d] a conflict between a perfected security interest and a right of setoff." Id. ¶ 42. As in Simplot, this case clearly "closely resembles" the same conflict.

See, e.g., Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 21 (1995) (acceptance of deposit "consists of nothing more or less than a promise to pay, from the bank to the depositor"). Therefore, when Great Basin wired the \$900,000 into the Concentration Account, Wells Fargo owed Great Basin \$900,000, while at that time, Great Basin owed Wells Fargo \$828,951.36 for the overdraft advances. The bank used Great Basin's debt to it to "cancel out" most of the bank's obligation to Great Basin, making only \$71,000+ available. (See Volvo Finance Opening Br. Add. Ex. 3, at 8.) This is plainly a setoff.²⁰

At any rate, whether Wells Fargo's actions can be labeled a "setoff" is not the ultimate issue; the real issue is whether Wells Fargo's actions differed from the bank's actions in Insley in any appreciable way. They clearly did not. Wells Fargo appears to claim that the setoff in Insley was "involuntary," while the setoff in the present case was "voluntary," but there is no basis for drawing such a distinction. In Insley, as in the pre-

²⁰ See, e.g., Farmers & Merch. Bank v. Universal C.I.T. Credit Corp., 315 P.2d 653, 657 (Utah 1957) ("[W]hen a depositor is indebted to a bank and the debts are mutual -- that is, between the same parties and in the same right -- the bank may apply the deposit, to the payment of the debt due it by the depositor, provided there is no express agreement to the contrary and the deposit is not specifically applicable to some other particular purpose."); 10 Am. Jur. 2d Banks & Fin. Inst. § 865, at 702 (2d ed. 1997) ("While this right [to apply a customer's deposit to a debt] has been called a lien, *this right of a bank with respect to general deposits is more accurately a right of setoff*, for it rests upon, and is coextensive with, the right to set off as to mutual demands.") (emphasis added); C&H, 449 N.W.2d at 876 ("It is a common setoff situation, whereby the bank attempted to recover Schellhorns' debt to it (from the payment of overdrafts) by offsetting that debt against its own debt to Schellhorns (from the deposit of grain proceeds).").

Wells Fargo also claims in its brief that a setoff requires "separate transactions." (See Wells Fargo Br. at 33 n.19 (citing Mark VII Fin. Consultants v. Smedley, 792 P.2d 130, 132 (Utah App. 1990).) Once again, one must question Wells Fargo's good faith in raising this argument. As even a cursory glance at Mark VII reveals, the court there was discussing the term "setoff" as it was used in the *pleading* context, i.e., setoff vs. recoupment. See 792 P.2d at 132-33. That issue has absolutely *nothing* to do with Insley, or with this case.

sent case, the debtor willingly deposited funds into his overdrawn account, and the bank subtracted the overdraft amount from the amount of the deposit. Because it is universal practice for a bank to take a setoff in this situation, the debtor in Insley obviously "consented" to it: "A general deposit . . . made when the deposit account is overdrawn[] *raises an implied consent to the application of the deposit to such overdraft or obligation.*" 10 Am. Jur. 2d Banks & Fin. Inst. § 865, at 702 (2d ed. 1997) (emphasis added). In other words, everyone *knows* that when one deposits funds into an overdrawn account, the bank will subtract the overdraft from the deposit. There is no reason to think that the deposit and setoff in Insley were any less voluntary than the deposit and setoff in the present case.²¹

Further, Wells Fargo has not explained why it should *matter* whether the seizure of funds is deemed "voluntary." The purpose behind Insley was to further certainty and efficiency in commercial transactions by relieving creditors of the obligation to police a debtor's use of collateral and by allowing a creditor to rely on its compliance with the UCC filing requirements to protect its interests against junior creditors. See Insley, 717 P.2d at 1345-46. Insley also recognized that in these situations, the bank can "most easily and least expensively" avoid these problems by not advancing funds to debtors who are already in default. See id. at 1346. Allowing a bank to keep proceeds seized from a debtor's account harms these interests no matter how "voluntary" the seizure.

²¹ Textron's statement that a transaction cannot constitute a "setoff" unless it is involuntary is unpersuasive, as Textron cites no authority for that statement. See Textron, 579 N.W. at 52. Further, as explained in the text, the ultimate issue is not whether Wells Fargo's actions fit within some technical definition of "setoff," but whether Wells Fargo's actions are distinguishable from the bank's actions in Insley. They are not.

Because this case is indistinguishable from Insley, this case is governed by Insley's holding that a creditor's perfected security interest takes precedence over "an unrecorded interest of a setting-off bank." Insley, 717 P.2d at 1346. Accordingly, Wells Fargo may not escape liability by claiming that it was not specifically informed that the funds at issue were subject to Volvo Finance's security interest.²²

- b. The weight of out-of-state authority also holds that a bank is liable for conversion when it seizes proceeds from a debtor's account to repay itself for overdraft advances.

Even if Insley were not controlling, Wells Fargo's ordinary course defense would still have to be rejected as a matter of law. First, under the plain language of Comment 2(c), the defense applies only if funds are "covered into the debtor's checking account and paid out in the operation of the debtor's business." Former UCC 9-306, cmt. 2(c). That is not what happened here, as Great Basin did not make a payment to Wells Fargo. Instead, Great Basin merely deposited funds into its own checking account, and Wells Fargo automatically debited the account to repay the advances.

In one of the seminal cases in this area, the Indiana Court of Appeals expressly held that the ordinary course defense could not apply without such a payment. See Citi-

²² In its argument, Wells Fargo cites certain "policies" discussed by the court in Harley-Davidson Motor Co. v. Bank of New England, 897 F.2d 611 (1st Cir. 1990), favoring banks over creditors. Notably, in Harley-Davidson, the court held that a bank was not entitled to summary judgment under the ordinary course defense on the financier's claim for the bank's conversion of proceeds of vehicles financed by the plaintiff, id. at 623, so it is hard to see how that case could help Wells Fargo. More importantly, however, in Insley, the Utah Supreme Court relied on *different* policies, favoring the need for creditors to be able to rely on their UCC filings to protect their security interests, so as to obviate the need to police security, and ease the sale of inventory in commerce. See Insley, 717 P.2d at 1345-46. Once again, Insley must control.

zens Nat'l Bank v. Mid-States Dev. Co., 380 N.E.2d 1243, 1250 (Ind. App. 1978). In Citizens National Bank, the court held that the ordinary course defense could not apply when a bank seized funds directly from the depositor's account:

In our view the security interest in proceeds continues until the funds are actually transferred in the ordinary course of business. ***Here no such transfers were made because of the Bank's conversion of the funds deposited in Huntington's account.*** Thus, diminishing [the secured creditor's] recovery would in no way protect transferees in the ordinary course of business. ***Instead it would provide a windfall by placing the Bank in a better position than it would have been if it had not converted the bank account to its own use.***

Id. (emphasis added). Thus, without an actual payment from Great Basin to Wells Fargo, the ordinary course defense cannot apply.

Further, as Volvo Finance explained in its opening brief, the weight of authority from other jurisdictions rejects the ordinary course defense in situations like this. See Bank of Brewton v. GMAC, 811 F. Supp. 648, 650-51 (S.D. Ala. 1992); C & H, 449 N.W.2d at 876-77 (Iowa 1989); Linn Coop. Oil Co. v. Norwest Bank Marion, 444 N.W.2d 497, 499 (Iowa 1989) ("Within the context of this conclusion, we are unable to conclude that the official comment accompanying section [9-306] rises to the status of a Code priority rule."); Citizens Nat'l Bank, 380 N.E.2d at 1248-50; GMAC v. Lincoln Nat'l Bank, 18 S.W.3d 337, 339-40 (Ky. 2000). See also Farmers & Merch. Nat'l Bank v. Sooner Coop., 766 P.2d 325, 330 (Okla. 1988) ("F&M's filed financing statement . . . provided sufficient information to put appellants on inquiry as to F&M's security interest in cash proceeds in the form of PIK benefits. Due to this knowledge, the transfer was not in the ordinary course of business and was subject to F&M's security interest."). Wells

Fargo attempts to distinguish these cases on the ground that they involved "involuntary" setoffs, but Wells Fargo's argument is no more persuasive here than it was in Wells Fargo's attempt to distinguish Insley.

Wells Fargo also asks the Court to follow J.I. Case and Textron, but as explained above, both cases started from the premise that Comment 2(c) provided a defense, and neither case involved setoffs to repay overdraft advances. This last point is highly significant because it goes directly to the equities of the situation. It may not be realistic to expect a bank to investigate a customer's financial condition every time the bank receives a payment on a pre-existing loan. But there is nothing wrong with asking a bank -- like every other creditor -- to do a little homework before lending out hundreds of thousands of dollars. As Wells Fargo admits, it could have done a UCC search and discovered Volvo Finance's interest, but it failed to do *any* investigation. Wells Fargo chose to loan money to an entity that was entirely uncreditworthy and whose assets were already pledged away. Justice demands that Wells Fargo bear the risk of default.

2. Wells Fargo has not shown that the defense applies as a matter of law.

Finally, Wells Fargo has not cited undisputed evidence entitling Wells Fargo to judgment as a matter of law on the ordinary course defense. There is no evidence that Great Basin made a "payment" to Wells Fargo in the "routine operation" of Great Basin's business. Cf. HCC Credit Corp. v. Springs Valley Bank & Trust, 712 N.E.2d 952, 958 (Ind. 1999) (identifying elements of claim; holding that summary judgment not appropriate because application of defense is question of fact). In HCC, the court held that the debtor's payment to the bank was not in the ordinary course because the bank was aware

that the plaintiff had a perfected security interest in the debtor's tractor inventory, and the payment was unusually large. See id. at 959.

Wells Fargo discusses at length Great Basin's "cash management system" and the way Great Basin normally made payments through that system (Wells Fargo Br. at 49-50), *but Great Basin did not use that system to pay Wells Fargo*. Instead, Wells Fargo bypassed the cash management system entirely and simply took the funds straight from the Concentration Account. The record does not reflect a single instance, other than the setoffs Wells Fargo took on December 27 and 29, in which Great Basin paid a "business expense" directly from the Concentration Account. Thus, Wells Fargo has not established that Great Basin repaid the overdraft advances in the routine operation of its business. (Once again, that the transaction was out of the ordinary suggests that it would have been reasonable for Wells Fargo to investigate Great Basin's financial situation before going through with the advances.)

Second, Wells Fargo has not established that it was unaware it was acting to Volvo Finance's prejudice in seizing Great Basin's funds on December 29. When Wells Fargo decided to cover Great Basin's overdrafts on December 27 and 28, Wells Fargo knew that the funds Great Basin was going to transfer to the Concentration Account were likely to be proceeds of Great Basin's inventory, knew that Great Basin's floor plan financing was provided by Volvo Finance, and knew that Great Basin's flooring obligations to Volvo Finance were secured by Great Basin's inventory. (See R. 1004-05.) Thus, even apart from Volvo Finance's UCC filing, Great Basin had *actual knowledge* of Volvo Finance's claim to the funds at issue. Moreover, because the funds from all twelve

Great Basin dealerships were automatically transferred every day to the Concentration Account, which was overdrawn, Wells Fargo knew that *none* of the dealerships had any funds on hand.

In HCC, the court held that the bank could not rely on the ordinary course defense because the bank "had extended credit to [the debtor] with the express understanding that HCC stood in a superior position to be repaid, at least in certain circumstances." HCC, 712 N.E.2d at 959. The court held that it would have been a "windfall" for the bank to be paid ahead of the debtor's secured creditors "because the bank had no reasonable expectation that [the debtor] could or would liquidate its debt due the bank in advance of paying HCC for the tractors financed -- at the expense of HCC which had taken all measures required by the U.C.C. to protect its interest." Id. That reasoning applies here: Wells Fargo admits knowing that Volvo Finance had a security interest in Great Basin's inventory and a superior right to repayment, and thus Wells Fargo had no "reasonable expectation" that any loan it advanced to Great Basin would be paid ahead of Volvo Finance, which, like the secured creditor in HCC, had "taken all measures required by the U.C.C. to protect its interest." Id. Thus, even if the ordinary course defense could apply in this case, there would be a genuine issue of fact as to whether Wells Fargo has met the requirements of that defense.

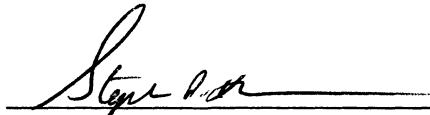
CONCLUSION

The case law is clear: Volvo Finance did not lose its security interest in the proceeds of the sales of the Volvo-Financed Vehicles simply because Great Basin transferred those funds from the Concentration Account to the First Security Account and

back. And Insley establishes that Wells Fargo committed a conversion and was unjustly enriched when it seized those proceeds from the Concentration Account to repay itself for overdraft advances. Accordingly, the Court should reverse the grant of summary judgment to Wells Fargo and allow Volvo Finance to go forward on its claims.

DATED: September 20, 2006.

ANDERSON & KARRENBURG

A handwritten signature in black ink, appearing to read "Steve P. Horvat", is written over a horizontal line.

Thomas R. Karrenberg

Stephen P. Horvat

Heather M. Sneddon

Counsel for Plaintiff-Appellant

CERTIFICATE OF SERVICE

On this 26th day of September, 2006, I caused two true and correct copies of the foregoing **APPELLANT'S REPLY BRIEF** to be served via U.S. Mail, postage prepaid, to the following:

James S. Jardine
Elaine A. Monson
Ray Quinney & Nebeker
36 South State Street, Suite 1400
Salt Lake City, Utah 84111



ADDENDUM EXHIBITS

11. Restatement (2d) of Trusts § 202.

Tab 11

C

**Restatement of the Law -- Trusts
Restatement (Second) of Trusts
Current through September 2004**

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**Chapter 7. The Administration Of The Trust
Topic 4. Remedies Of The Beneficiary And Liabilities Of The Trustee**

§ 202. Following Trust Property Into Its Product

[Link to Case Citations](#)

(1) Where the trustee by the wrongful disposition of trust property acquires other property, the beneficiary is entitled at his option either to enforce a constructive trust of the property so acquired or to enforce an equitable lien upon it to secure his claim against the trustee for damages for breach of trust, as long as the product of the trust property is held by the trustee and can be traced.

(2) Except as stated in Subsection (1), the claim of the beneficiary against the trustee for breach of trust is that of a general creditor.

See Reporter's Note.

Comment on Subsection (1):

a. Constructive trust or equitable lien. Where the trustee by the wrongful disposition of trust property acquires other property which is or becomes more valuable than the trust property used in acquiring it, the beneficiary is entitled to reach the property so acquired, and thus to secure the profit which arises from the transaction. Where, on the other hand, the property acquired is or becomes less valuable than the trust property used in acquiring it, the beneficiary can hold the trustee personally liable for the value of the trust property so used, and can enforce an equitable lien upon the property so acquired as security for his claim against the trustee, holding the trustee personally liable for the balance of his claim. Since the transaction is in breach of trust, the trustee is accountable for profits and is chargeable with losses arising therefrom.

The advantage to the beneficiary in thus following trust property into its product is that he is enabled thereby to reach the profit, if any, resulting from the disposition, and that whether there is a profit or not he is enabled to obtain priority over the general creditors of the trustee to the extent to which he can trace trust property into the product. The equitable interest of the beneficiary in the product of trust property can be enforced against the trustee and against any third person claiming an interest in the product, unless the third person is a bona fide purchaser. See § 284. A creditor of the trustee is not a bona fide purchaser. See § 308.

As to the choice of remedies where there are several beneficiaries, see § 214.

The rule stated in Subsection (1) is applicable where the trustee wrongfully sells trust property, or wrongfully

uses trust funds in the purchase of property, or wrongfully exchanges trust property for other property, or wrongfully deposits trust funds in a bank. The Statute of Frauds does not preclude the beneficiary of an oral trust of a chattel or chose in action which the trustee has exchanged for an interest in land from reaching the land. See § 52, Comment *c*.

Illustrations:

1. A is trustee for B of Blackacre. In breach of trust he sells Blackacre, and receives \$10,000 which he still holds. B can enforce a constructive trust of the proceeds, or he can hold A liable for the value of Blackacre and enforce an equitable lien upon the proceeds.

2. A is trustee for B of \$10,000. In breach of trust he purchases Blackacre with the money. B can enforce a constructive trust of Blackacre, or he can hold A liable for \$10,000 and enforce an equitable lien upon Blackacre.

3. A is trustee for B of certain bonds. In breach of trust he exchanges the bonds for certain shares of stock. B can enforce a constructive trust of the shares of stock, or he can hold A liable for the value of the bonds and enforce an equitable lien upon the shares of stock.

4. A is trustee for B of \$10,000. In breach of trust A deposits the money in his individual account in a bank in which he has on deposit no individual funds. The bank fails and pays fifty cents on the dollar. B is entitled to the \$5000 received from the bank, and can hold A personally liable for the balance of the \$10,000.

b. Successive transactions. The rule stated in Subsection (1) is applicable not only with respect to property acquired immediately through the wrongful disposition of trust property, but also with respect to property subsequently acquired through the disposition of the property so first acquired. This is true although there have been many such successive transactions, so long as it is shown that the property ultimately held by the trustee was acquired through the wrongful disposition of the trust property or its product.

Illustration:

5. A is trustee for B of Blackacre. In breach of trust A sells Blackacre for \$10,000, and with \$5000 of the proceeds he purchases Whiteacre and with the other \$5000 purchases bonds. He exchanges Whiteacre to Greenacre. B can enforce a constructive trust of Greenacre and the bonds, or he can hold A liable for the value of Blackacre and enforce an equitable lien upon Greenacre and the bonds.

As to the liability of the trustee with respect to an intermediate profit or loss, see § 213, Comment *l*.

c. Aleatory transactions. The rule stated in Subsection (1) is applicable where the trustee by the wrongful disposition of trust property acquires other property, even though the transaction is an aleatory transaction, that is one involving a large element of risk of loss and possibility of profit. In such a case if there is a profit realized, the beneficiary is entitled to reach it; and if there is a loss he can hold the trustee personally liable and can enforce an equitable lien upon the product, if any, of the trust property.

Illustrations:

6. A is trustee for B of \$1000. He wagers the \$1000 on a horse race and wins \$10,000. B can enforce a constructive trust of the \$10,000.

7. A is trustee for B. A insures his own life for \$10,000 and pays the premiums wholly with funds of the trust. After two years A dies. B can enforce a constructive trust of the proceeds of the policy, and is not limited to a lien upon the proceeds for the amount of trust funds used in paying the premiums.

d. Acquisition of property exempt from claims of creditors. The rule stated in Subsection (1) is applicable where the trustee by the wrongful disposition of trust property acquires other property, even though the property so acquired is of such a character that it cannot be reached by general creditors of the trustee. The policy in favor of exempting certain property from the claims of creditors is not applicable where the property is wrongfully acquired with the property of another.

Illustrations:

8. A, trustee for B, wrongfully takes \$2000 of the trust funds and purchases a homestead which by law is not subject to attachment or levy on execution by his creditors. B can follow the money into the property so acquired and compel A to hold it in constructive trust for him, or can enforce an equitable lien upon the property.

9. A is a trustee for B. A insures his own life for \$10,000 and pays the premiums wholly with funds of the trust. After two years A dies. By statute the proceeds of life insurance policies are exempt from the claims of creditors of the insured. B can enforce a constructive trust of the proceeds of the policy.

e. Proceeds of the use of trust property. The rule stated in Subsection (1) is applicable not only where the trustee acquires property by a wrongful sale, purchase or exchange, but also where he acquires property from the wrongful use of trust property. Thus, if the trustee wrongfully leases trust property, the beneficiary can enforce a constructive trust of or an equitable lien upon the rental received by the trustee. So also, if the trustee wrongfully uses trust money in his own business, or if he lends trust money to himself, the beneficiary can impose a constructive trust or equitable lien upon the proceeds if he can trace them.

f. Improvements upon trustee's individual property. Where the trustee wrongfully uses trust funds to pay for improvements upon property owned by the trustee individually, the beneficiary is entitled to an equitable lien upon the property but cannot compel the trustee to hold the property upon a constructive trust for him, since the trust funds were not used in acquiring the property.

Illustration:

10. A is trustee for B of \$1000. He wrongfully uses this money in making improvements upon Blackacre, owned by A individually. B can enforce an equitable lien upon Blackacre for \$1000, but he cannot enforce a constructive trust of Blackacre.

g. Discharging trustee's individual obligation. Where the trustee wrongfully uses trust funds in discharging an obligation owed by the trustee individually to a third person, the beneficiary is entitled to be subrogated to the rights which the obligee had before the obligation was discharged. A court of equity will afford relief to the beneficiary by putting him in the position occupied by the obligee before the obligation was discharged. If the obligation was a secured obligation, the beneficiary is entitled to the security interest held by the obligee. If the obligation was of such a character that the obligee was entitled to priority over other creditors of the trustee, the beneficiary is entitled to a similar priority. On the other hand, if the obligation discharged was not secured and the obligee was not entitled to priority, although the beneficiary is entitled to be subrogated to the rights of the obligee, he does not thereby obtain any priority over other creditors of the trustee, and his remedy by way of subrogation is no better than that which he has against the trustee to recover damages for the wrongful disposition of the trust property. On the question of the liability of the obligee if he had notice of the breach of trust, see § § 288 and 304.

Illustrations:

11. A is trustee for B of \$10,000. A uses the trust money in paying off a mortgage of \$10,000 upon Blackacre, which belongs to A individually. B is subrogated to the rights which the mortgagee had prior to the discharge of the mortgage.

12. A is trustee for B of \$5000. A is individually indebted to a bank in the sum of \$5000, the debt being secured by a pledge of bonds owned by A. A uses the trust money in paying the debt. B is subrogated to the security interest which the bank had prior to the payment of the debt.

13. A, trustee for B, wrongfully takes \$1000 of the trust money and pays personal taxes owed by A to a city. Such taxes are by statute payable out of the assets of an insolvent taxpayer in priority to other claims. A is insolvent. B is entitled to the same priority to which the city was entitled.

h. Mingling trust property with individual property of the trustee. Where the trustee wrongfully mingles trust

property with his individual property in one indistinguishable mass, the beneficiary is entitled at his option either to enforce a constructive trust on the mingled property in such proportion as the trust property so mingled bears to the whole of the mingled property, or to enforce an equitable lien upon it to secure his claim against the trustee for the value of the trust property so mingled. So long as no further disposition is made of the mingled mass, and so long as it does not fluctuate in value, the result is the same whichever remedy is enforced by the beneficiary.

Where the trustee exchanges the mingled mass for other property, the beneficiary is entitled at his option either to claim a proportionate share of the product, or to enforce an equitable lien upon it to secure his claim for reimbursement. Where the property is or becomes more valuable than the mingled mass with which it is acquired, the beneficiary is entitled to a proportionate share of the property, and thus to secure the profit which arises from the transaction. Where, on the other hand, the property acquired is or becomes less valuable than the mingled mass with which it is acquired, the beneficiary can enforce an equitable lien upon the property as security for his claim against the trustee.

Illustrations:

14. A is trustee for B of \$1000. With this money and with \$1000 of his own money A purchases Blackacre. B is entitled at his option to enforce a constructive trust as to a half interest in Blackacre, or to an equitable lien upon Blackacre for \$1000.

15. A is trustee for B of \$1000. With this money and with \$1000 of his own money A purchases shares of stock which he later sells for \$5000. B is entitled to receive half of the proceeds. If the shares are sold for \$1500, B is entitled at his option to an equitable lien upon the proceeds for \$1000.

16. A is trustee for B. A insures his own life for \$10,000 and pays the premiums half with trust funds and half with money of his own. A dies. B is entitled to half of the proceeds of the policy, or at his option he is entitled to an equitable lien upon the proceeds for the amount of premiums paid with trust funds.

i. Effect of withdrawals from the mingled mass. Where the trustee wrongfully mingles trust funds with his individual funds in one indistinguishable mass, and subsequently makes withdrawals from the mingled fund, the beneficiary is entitled to a proportionate share both in the part which remains and in the part which is withdrawn, or at his option he is entitled to an equitable lien upon both parts to secure his claim for reimbursement.

Where the trustee deposits in a single account in a bank trust funds and his individual funds, and subsequently makes withdrawals from the bank account and dissipates the money so withdrawn, the beneficiary is entitled to an equitable lien upon the balance remaining in the bank for the amount of trust funds deposited in the account. It is immaterial in what order the deposits were made, whether the trust funds were first deposited or the trustee's individual funds, since there is no inference that the money first deposited is the money first withdrawn. The rule in Clayton's Case that withdrawals are presumed to be in the same order as that in which the deposits were made, has no application to this situation, where the intention of the wrongdoing trustee in making withdrawals is immaterial. The beneficiary's lien is not restricted to any part of the deposit but extends to the whole deposit and can be enforced against any part of the funds remaining on deposit and against any funds which are withdrawn, so long as they can be traced. So also, there is no inference that the trustee withdraws his own funds first. If the funds withdrawn are preserved or can be traced, the beneficiary can enforce an equitable lien upon them or their product, even though the funds remaining on deposit are subsequently dissipated.

Illustrations:

17. A is trustee for B of \$1000. He deposits this money in his individual account in a bank where he has \$1000 of his own on deposit. He draws out \$1000 and buys securities. B is entitled to one-half of the securities and one-half of the money remaining on deposit or at his option to an equitable lien upon the securities and the deposit for \$1000.

18. A is trustee for B of \$1000. He deposits this money in his individual account in a bank where he has \$1000 of his own on deposit. He draws out and dissipates \$1500. B is entitled to an equitable lien upon the balance of the deposit.

19. A is trustee for B of \$1000. He deposits this money in his individual account in a bank where he has \$1000 of his own on deposit. He draws out \$500 with which he buys securities, and subsequently draws out the

balance of \$1500 which he dissipates. B is entitled to one-half of the securities or at his option to an equitable lien upon the securities for \$1000.

On the question as to whether and under what circumstances the trustee can properly separate the mingled fund so as to confine the beneficiary to a particular part of the fund and its proceeds, see Restatement of Restitution, § 211, Comment *e*.

j. Effect of withdrawals and subsequent additions. Where the trustee deposits in a single account in a bank trust funds and his individual funds, and makes withdrawals from the deposit and dissipates the money so withdrawn, and subsequently makes additional deposits of his individual funds in the account, the beneficiary cannot ordinarily enforce an equitable lien upon the deposit for a sum greater than the lowest intermediate balance of the deposit. If the amount on deposit at all times after the deposit of the trust funds equalled or exceeded the amount of trust funds deposited, the beneficiary is entitled to a lien upon the deposit for the full amount of the trust funds deposited in the account. If after the deposit of trust funds in the account the deposit was wholly exhausted by withdrawals before subsequent deposits of the trustee's individual funds were made, the beneficiary's lien upon the deposit is extinguished, and if he is unable to trace the money withdrawn, he is relegated to a mere personal claim against the trustee, and is entitled to no priority over other creditors of the trustee.

Illustrations:

20. A is trustee for B of \$1000. He deposits this money together with \$1000 of his own in a bank. He draws out \$1500 and dissipates it. He later deposits \$1000 of his own in the account. B is entitled to a lien on the account for \$500, the lowest intermediate balance.

21. A is trustee for B of \$1000. He deposits this money together with \$1000 of his own in a bank. He draws out the whole \$2000 and dissipates it. He later deposits \$500 of his own. B is not entitled to a lien on the account.

22. A is trustee for B of \$1000. He deposits this money together with \$1000 of his own in a bank. He draws out various amounts and makes further deposits of money of his own. The amount on deposit in the account is at no time less than \$1000. B is entitled to a lien on the account for \$1000.

k. Investment of lowest balance. Where the lowest balance is invested and earns a profit, the beneficiary can enforce an equitable lien not only for the amount of the lowest balance but also for the amount of the profit earned by it, although not for more than the total amount of the trust fund wrongfully mingled by the trustee. The beneficiary is entitled at his option to enforce a constructive trust as to a proportionate share of the product.

Illustration:

23. A, trustee for B, deposits \$1000 of trust funds in his individual account in a bank, together with \$1000 of his own. A withdraws and dissipates \$1500. He invests the remaining \$500 in shares of stock which he sells for \$1500. B is entitled to a lien on the proceeds for \$1000. If he sells the shares for \$3000, B is entitled at his option to enforce a constructive trust as to one-half of the proceeds or \$1500.

l. Redeposit of withdrawals. Where the amount withdrawn from the account is not dissipated but is subsequently redeposited in the account, the effect is the same as though the withdrawal had not been made, and the beneficiary's lien is not limited to the lowest intermediate balance.

Illustrations:

24. A is trustee for B of \$1000. He deposits this money together with \$1000 of his own in a bank. He draws out \$1500 of which he dissipates \$1000 and redeposits the remaining \$500 in the account. B is entitled to a lien on the account for \$1000.

25. A is trustee for B of \$1000. He deposits this money together with \$1000 of his own in a bank. He draws out the whole \$2000 with which he purchases shares of stock which he later sells for \$1500 which he redeposits in the account. B is entitled to a lien on the account for \$1000.

m. Subsequent additions by way of restitution. Where the trustee deposits trust funds in his individual account in a bank, and makes withdrawals from the deposit and dissipates the money so withdrawn, and subsequently makes additional deposits of his individual funds in the account, manifesting an intention to make restitution of the trust funds withdrawn, the beneficiary's lien upon the deposit is not limited to the lowest intermediate balance.

Where the deposit of trust funds and of his individual funds was in an account in the name of the trustee as such, and not in his individual account, and he withdraws more than the amount of his individual funds, and subsequently deposits his individual funds in the account, the beneficiary's lien upon the deposit is not limited to the lowest intermediate balance since the new deposit will be treated as made by way of restitution of the trust funds previously withdrawn.

n. Mingling funds of two or more trusts. Where a trustee wrongfully mingles property held by him as trustee under different trusts and exchanges the mingled mass for other property, the beneficiaries of the trusts are entitled to enforce a constructive trust on the property so acquired and are entitled to share the property proportionately.

Illustrations:

26. A wrongfully takes \$1000 which he holds in trust for B and \$2000 which he holds in trust for C, and with this \$3000 purchases Blackacre, which he later sells for \$6000. Out of the proceeds B is entitled to \$2000 and C is entitled to \$4000.

27. The facts are as stated in Illustration 26, except that A sells Blackacre for \$1200. Out of the proceeds B is entitled to \$400 and C is entitled to \$800. B can also hold A personally liable for \$600 and C can hold A personally liable for \$1200.

Where the trustee deposits in a single account funds held by him as trustee under different trusts, and subsequently wrongfully withdraws and dissipates a part of the deposit, the beneficiaries of the trusts are entitled to share the balance of the deposit proportionately, regardless of the order in which the deposits were made.

Illustrations:

28. A wrongfully deposits in his personal account in a bank \$1000 which he holds in trust for B and \$2000 which he holds in trust for C. A draws out and dissipates \$1500. Of the balance remaining B is entitled to \$500 and C is entitled to \$1000. B can also hold A personally liable for \$500 and C can hold A personally liable for \$1000.

29. A wrongfully deposits in his personal account in a bank \$1000 which he holds in trust for B and \$1000 which he holds in trust for C. A has also \$1000 of his own in the account. A draws out and dissipates \$1500. Of the balance remaining B is entitled to \$750 and C is entitled to \$750.

By the Uniform Trusts Act, § 15, it is provided that where a trustee mingles the funds of two or more trusts and subsequently makes a withdrawal for his own benefit or for the benefit of a third person or for an unknown purpose, such withdrawal shall be charged first to the amount of property of the trustee in the mingled funds, if any, and then proportionately to the several trusts. See Restatement of Restitution, § 213.

Comment on Subsection (2).

o. Necessity of tracing trust property. The claim of the beneficiary against the trustee for breach of trust does not of itself entitle him to priority over the general creditors of the trustee. Thus, if the trustee sells trust property and dissipates the proceeds, the beneficiary is not entitled to priority over other creditors of the trustee. The beneficiary is entitled to priority only if and to the extent that he can trace the trust property into a product. He must prove not only that the trustee once had the trust property or its product, but that he still holds the trust property, or property which is in whole or in part the product of the trust property. As has been stated, the mere fact that the trust property or its proceeds has been mingled with the trustee's individual property in one indistinguishable mass does not prevent the beneficiary from following the trust property and obtaining in part at least priority over the trustee's general creditors. But if it is shown that the property or its proceeds has been dissipated so that no product remains, or if the beneficiary fails to prove that the trustee still has property into which the trust property is traceable, his

claim is only that of a general creditor of the trustee.

If the trustee is also a beneficiary of the trust, the other beneficiaries are entitled to a charge upon the trustee's beneficial interest to secure their claims against the trustee for breach of trust. See § 257.

Comment:

p. Cross references. As to the power of the beneficiary to reach the trust property or its product in the hands of a third person, see § § 284 and 326.

The general rule as to the following into its product of property wrongfully disposed of is not limited to trust property. As to the application of the rule to other wrongdoers, as well as to trustees, see Restatement of Restitution, § § 202-215.

Case Citations

Reporter's Notes & Cross References through December 1958

Case Citations January 1959 -- June 1986

Case Citations July 1986 -- June 2003

Reporter's Notes & Cross References through December 1958:

REPORTER'S NOTES

The principles as to following property into its product are applicable not only to trustees but to other fiduciaries and to non-fiduciaries who have wrongfully dealt with the property of another. Accordingly, the question of following property into its product is dealt with in the Restatement of Restitution, § § 202-215.

For cases dealing with this matter, see 4 Scott on Trusts (2d ed.1956) § § 507- 522; Bogert, Trusts and Trustees, § § 921-930.

Cross References to

Digest System Key Numbers

Trusts  349

Case Citations January 1959 -- June 1986:

C.A.D.C.1969. Cit. com. i in fn. in sup. This action arose out of a dispute over the distribution of swindled funds among numerous victims. The court held that the distribution of funds recovered from a confidence man who swindled different victims at different times and then commingled the lucre was properly distributed to the victims on a pro rata basis, according to their respective losses. *Ruddle v. Moore*, 134 App.D.C. 3, 411 F.2d 718, 719.

C.A.D.C.1977. Cit. in fn. This was an action on a petition for involuntary reorganization of an insolvent corporation. Plaintiffs, investors, had invested funds in various limited partnerships that were organized to purchase and operate real estate holdings but such funds were diverted, without their knowledge, to purchase real estate by a corporation which subsequently became insolvent. Reversing the lower court's dismissal of plaintiff's complaint on the basis that since they were "shareholders," they were ineligible to file a petition for reorganization, the court held that the diversion of plaintiffs' funds created a constructive trust such that they held an equitable lien against the property of the corporation, and as they could be characterized as "secured creditors", they were eligible to file the

petition for reorganization. In re Lela & Co. Inc., 551 F.2d 399, 407.

N.D.Cal.1984. Com. (m) cit. in sup. The United States sued the former president of a bankrupt company for nonpayment of taxes withheld from employees' salaries. An action was also brought against the defendant's attorneys, who accepted payment to represent the company in the bankruptcy proceedings knowing that the company was incapable of meeting its obligations to the government. The attorneys moved for summary judgment, arguing that funds held in trust for the government could not be traced into their hands. This court denied the motion, holding, inter alia, that the trust funds were not depleted when an overdraft was created on the company's bank account, since the trust was revived by subsequent deposits specifically intended for payment of the taxes, but later paid to the attorneys. *Alioto v. United States*, 593 F.Supp. 1402, 1411.

D.Colo.Bkrcty.Ct.1986. Coms. (i) and (j) cit. in fn. in disc. A group of debtors brought an adversary proceeding for turnover and for a determination of whether the Farmers Home Administration (FmHA) retained a perfected security interest in proceeds from the debtor's 1984 potato crop. The court held that the FmHA had an enforceable security interest in the cash proceeds, because the proceeds were traceable to the proceeds of the debtor's 1983 potato crop in which the FmHA held a perfected security interest. The court stated that, in early 1984, the debtors deposited the checks from the 1983 crop into the supervised account. When those funds were withdrawn, they were deposited into the debtor's individual checking account. Even though these funds were commingled with other income, they were used in large part to pay the expenses incurred by the debtors to produce the 1984 crop. In re Hugo, 58 B.R. 903, 908.

E.D.Mo.1973. Quot. but dist. com. j and illus. 20, and quot. in sup. com. m. Plaintiff, a Delaware corporation, brought this action against the defendant, a Missouri banking corporation, contending that it had a perfected security interest in the proceeds of sales of certain automobiles, which proceeds were deposited in the debtor's account in defendant bank, and which the plaintiff alleged were thereafter permitted by the defendant to be withdrawn with the knowledge of the plaintiff's claim. The defendant argued that when the proceeds were deposited and thereby commingled with other funds in the automobile dealer's account, and thereafter substantial withdrawals were made exceeding the amount of the deposited proceeds, the proceeds completely lost their identity. Held: Subsequent deposit of funds not relating to the proceeds from the sale of the automobiles in the automobile dealer's individual d/b/a account were not to be treated as made by way of restitution of trust funds previously withdrawn. The court had examined the banking records of the automobile dealer's account and found that the identifiable proceeds in which the plaintiff held a continuous perfected security interest prior to the bank's \$12,000 debit entry was \$11,429.11. The plaintiff is entitled to recover from the defendant the excess amount debited, that amount is identified as proceeds in which the plaintiff had a perfected security interest, together with the 6% interest on that amount. Judgment for the plaintiff. *Universal C.I.T. Credit Corp. v. Farmers Bank of P.*, 358 F.Supp. 317, 325, 326.

S.D.N.Y.1967. Com. i and illus. 19 quot. in sup. A bank misappropriated funds, funneling them to a corporation which later went bankrupt. The Federal Deposit Insurance Corporation, a receiver of the bank, received certain mortgages from the bankrupt corporation, and the trustee of the bank brought suit and charged that the corporation's transfers to the FDIC were illegal and invalid. The court agreed and gave judgment for the trustee. The court also held that the FDIC held a valid equitable lien upon the bankrupt corporation's property to the extent that the FDIC could trace its money, even though the money had been mingled and some of this fund then dissipated. In re Anjopa Paper & Board Mfg. Co., 269 F.Supp. 241, 262.

S.D.Ohio Bkrcty.Ct.1982. Cit. in sup. The plaintiff, the transferor of stock in an oil and gas company, brought this action against the transferee, a Chapter XI debtor, seeking to regain the shares on the theory that the shares were subject to an express trust agreement between the transferor and the transferee which required the retransfer of such stock to the transferor. The court found that an agreement of express trust had been arrived at prior to the transfer of the stock, under which the defendant was to hold one-half, that is 250 shares, of a mutually-owned company for the benefit of the plaintiff. The court held that the plaintiff was entitled to the return of these shares and traced the shares handling by the defendant to determine the plaintiff's recovery. The court stated that the defendant subsequently increased the total shares in the mutually-owned company to 10,000, with 4,500 shares representing the equivalent of the 250 shares held in trust. After bankruptcy, the shares the defendant held in his company were exchanged at a 1 to 10 ratio for the shares of a new company. The court held that the plaintiff was entitled to the imposition of a constructive trust upon 45,000 shares of the new company, the equivalent value of the original 250 shares of the

plaintiff, which under the provisions of the bankruptcy plan would otherwise be issued to the defendant. In re F.L. Ross Enterprises, Inc., 19 B.R. 237, 250.

Ariz.App.1966. Quot. in sup. in ftn. The plaintiff-son sought a one-fourth proportional share of the proceeds of the sale of stock in a closely-held corporation from the defendant, his mother. This court upheld a judgment for the plaintiff-son on the grounds that the transaction to purchase the father's stock for future sale to third parties made the defendant-mother's claim for reimbursement untimely, since it was raised after trial for the first time. *Birth v. Birth*, 4 Ariz.App. 220, 419 P.2d 350, 352, 353, vacated 430 P.2d 136.

Ark.1960. Com. j cit. in sup. A hospital bought an adjoining lot from funds some of which belonged to the county. It had failed to separate its accounts. The court held that since it was undisputed that even after the purchase price of the lot had been paid the amount remaining in the hospital's account exceeded the amount it held in trust for the county, the purchase was not improper, so no lien in favor of the county existed. *Warren v. Wheatley*, 231 Ark. 707, 331 S.W.2d 843, 846.

Cal.1970. Cit. in sup. by diss. B purchased property from A for \$11,000, then A found a purchaser C, who would buy for \$12,500. The title company opened only one escrow to handle both transactions. B used the proceeds from C to pay A, using none of his own funds. When C decided to resell he learned his title was subject to judgment liens against B, amounting to approximately \$50,000. C had never heard of B, having transacted through agents. On action by C, the court held that C was liable for the liens on the theory that during the scintilla of time B owned the property the liens attached. Two dissents argued that C was not liable because B and his wife were trustees, since they had only naked title and could only pass on title to C, and no liens attached. The first dissenter relied on a statutory presumption of intention for a resulting trust to arise by operation of law. The second dissenter maintained that if B knew or should have known of the abstracts of judgment failure to disclose this fact was fraud; if B did not know, the transaction respecting the title conveyed by B was tainted by mutual mistake. Both fraud and mistake were statutory grounds for the imposition of a constructive trust. *Majewsky v. Empire Construction Company*, 2 Cal.3d 478, 85 Cal.Rptr. 819, 467 P.2d 547, 556.

Cal.App.1981. Cit. in disc. The trustees of an inter vivos trust, having both marital and nonmarital trust features, brought this action for declaratory relief to determine the propriety of their actions after the death of the trustor. The trust's assets included virtually all the stock of a newspaper corporation operated by the trustor. The trust required that death taxes and other costs be paid from the assets of the nonmarital trust, and directed that certain of the nonmarital trust's stock be sold to raise these funds. The trustees sold the stock back to the corporation, setting the price so as to avoid heavy income and death tax burdens on the trust. Two beneficiaries under the nonmarital trust objected, asserting that the stock was sold at a price below its fair market value. The trial court found that the stock redemption price was low, and the court adjusted the trust's holdings to reflect what the respective holdings of the marital and nonmarital trusts would have been, had the sale been made at the proper figure. The court further found that while the trustees had committed no fraud, they faced conflicting interests in performing their functions and had breached their fiduciary duty to the nonmarital trust beneficiaries; the court ordered that they be removed as trustees. The appellate court affirmed the trial court's revaluation of the stock. The sale of the nonmarital trust's stock below its fair market value worked to the detriment of the nonmarital trust, and the trial court was correct in ordering a transfer of stock from the marital trust in order to make the nonmarital trust whole. The court noted that the trial court incorrectly labeled its remedy a constructive trust when it was actually specific reparation. The higher court then reversed the trial court's order removing the trustees, finding that their acts were reasonable and did not justify discharge. *Copley v. Copley*, 126 Cal.App.3d 248, 178 Cal.Rptr. 842, 864.

Fla.App.1983. Com. (h) cit. in sup. One partner in a limited partnership induced the other partner to invest an amount of money disproportionate to his share in the partnership by misrepresenting his own investment in the partnership. The trial court found that the first partner, the defendant, had defrauded the second partner, the plaintiff, in violation of his fiduciary obligation. The trial court ruled that the defendant held his partnership interest in a constructive trust for the benefit of the plaintiff, and granted the defendant's entire partnership interest to the plaintiff. This court affirmed the finding of fraud. However, it reversed as to the relief granted. It held that the shares in the partnership should have been adjusted to comport with the actual investments made by each partner. *Malkus v. Gaines*, 434 So.2d 957, 963, petition for review denied 446 So.2d 100 (Fla.1984).

Kan.1974. Subsec. (1) quot. in sup. in syllabus by the court, quot. and fol., com. (g) cit. in sup. Plaintiffs, conservators of the estate of their parents, brought suit for an accounting and for other equitable relief. The action was the result of misappropriation of the parents' property by the son through misuse of powers of attorney. From judgment for plaintiffs, appeal was taken. Where a trustee, by the wrongful disposition of trust property, acquires other property, the beneficiary is entitled to either enforce a constructive trust of the property so acquired, or to enforce an equitable trust of the property so acquired, or to force an equitable lien upon it to secure his claim against the trustee for damages for breach of trust. Furthermore, if the trustee, in breach of trust, transfers trust property to a person who takes with notice of the breach, the transferee does not hold the property free of the trust. Each individual misappropriation of funds by defendant constituted a separate wrongful act and breach of trust. Plaintiffs had the right to exercise their option with respect to each individual transaction and to elect whether to proceed by way of a personal judgment or to follow the trust funds into the knowingly participated-in defendant's breach of trust, and each transferee is responsible to the extent of his participation. Notice of the conservatorship hearing precluded claims that appointment of the conservators was void. *Kline v. Orebaugh*, 214 Kan. 207, 519 P.2d 691, 693, 695, 696.

Mo.1965. Com. h cit. in sup. The plaintiff sought to establish a constructive trust over properties in the estate of the deceased who had falsely represented that he and the plaintiff had been legally wed and fraudulently procured money from her. The court held that the plaintiff was entitled to trust on one-half of a farm purchased with joint money and to money used for general marital purposes to be satisfied out of personalty accruing during their lives together. *McHenry v. Brown*, 388 S.W.2d 797, 806.

Mo.1972. Cit. in sup. This was an action to impress a constructive trust for plaintiff's children on proceeds of three life insurance policies. Plaintiff was the former wife of deceased. Incident to their divorce, deceased made a contract whereby he would make their children the beneficiaries of the life insurance policies he held. Deceased, however, did not change the named beneficiary, and when he died the insurance companies paid the proceeds to defendant, deceased's mother. Defendant knew of the contract, and after suit was brought commingled the proceeds with her own funds. Defendant claimed that she spent the proceeds. The court held that there was a constructive trust, and that when the depleted account was subsequently augmented by new deposits, the resultant balance would be treated as trust funds available to the beneficiaries. *Perry v. Perry*, 484 S.W.2d 257, 259.

Mo.App.1976. Com. (o) cit. in sup. This action was brought to impress a constructive trust on certain land. Although the plaintiff and the defendant had earlier agreed that legal title to the land would be taken in the plaintiff's name, the defendant, now an incompetent, took title in her name and refused to transfer it to the plaintiff. The trial court impressed the trust as prayed, and defendant, guardian of the incompetent's estate, appealed. In reversing the judgment on appeal, this court noted that to impress land with a trust, the money must be distinctly traced and clearly proved to have been invested in the land. According to the court, it must be clear that the lands have been paid for out of trust money. Moreover, in order to gain priority over the defendant's general creditors, the plaintiff had to prove that the defendant had property legally or equitably belonging to him, and that she still held that property. The court found that the plaintiff had failed to meet these standards of proof. *Owen v. Smith*, 532 S.W.2d 538, 540.

Mo.App.1978. Subsecs. (1) and (2) quot. in sup. and com. (o) quot. in sup. Plaintiffs, as administrators of a decedent's estate, instituted suit to impose an equitable lien on the assets of defendant's estate after his death. Plaintiffs claimed that defendant, as the executor of the decedent's estate after her death, confiscated certain of her funds for his personal use. The court affirmed an adverse ruling of the probate court, holding that plaintiffs were not entitled to an equitable lien. The stipulation of facts contained no tracing of any of the alleged trust property into the defendant's estate, and there was no suggestion of the comingling of defendant's personal funds. Thus appellants did not show that they had anything other than a general creditor's lien. *In re Estate of Wittenberg*, 577 S.W.2d 120, 121, 122.

N.Y.Surr.Ct.1983. Com. (n) cit. in sup. An attorney, now deceased, settled negligence claims for six clients. The first three settlements were deposited in an escrow account and some money was dispersed to the clients. Later, three more settlements were deposited and still remained at the time of the attorney's death. The last three clients claimed that since their settlements were directly traceable to the escrow account, only the settlements of the first

three were in dispute; thus they were to receive full payment of their claims before the first three received any more money. The court held that, as the earlier funds were partially dissipated and could no longer be traced, the first three clients had become common creditors and could only share proportionately in the balance remaining after payment to the last three clients. *Estate of Reece*, 122 Misc.2d 517, 470 N.Y.S.2d 974, 976.

Or.1976. Subsec. (1) cit. in fn. in sup. Plaintiff brought suit against her father to compel him to account for assets which she alleged were held by him as a trustee. From dismissal of her complaint, plaintiff appealed. The court reversed. As in the present case, it is enough to create a trust if the transfer of the property is made with the intent to vest the beneficial ownership in a third person. Defendant's purchase of stock as "custodian" for plaintiff was ineffectual to expend defendant's powers over the trust property from that of trustee to that of custodian. Thus, plaintiff was entitled to impose a constructive trust or an equitable lien upon the stock so acquired. The court went on to hold that a summary of trust expenditures, prepared from cancelled checks and a letter to plaintiff, was insufficient to meet the requirement that a trustee maintain complete and accurate records. It was, therefore, error for the trial court to conclude that plaintiff had received the accounting she sought. The case was thus remanded. *Jimenez v. Lee*, 274 Or. 457, 547 P.2d 126, 129.

Tex.Civ.App.1977. Subsec. (2)(g) quot. in sup. A husband and wife sought a divorce. In accordance with the findings of a jury, the trial court granted the divorce and ordered the property divided. The jury made fact findings as to the values of community property and improvements, found that the property should be divided equally, and that the wife should recover \$5700 in attorneys' fees from the husband. The wife appealed, and the husband cross-appealed. They primarily complained about the classifications and the valuations assigned to the property in the court's judgment. The husband also contended, inter alia, that the trial court erred in its reimbursement of the community estate for his use of community funds to pay his separate debts. The court held that the trial court did not abuse its discretion in reimbursing the community estate for the payment of the husband's separate debts out of community funds. The court also held, inter alia, that the evidence supported the jury's findings as to the values of the community property and improvements, and that the trial court did not err in ordering that the wife should recover attorneys' fees from the husband and in finding that the community estate should be divided equally. Therefore, the trial court's judgment was affirmed. *Trevino v. Trevino*, 555 S.W.2d 792, 798.

Case Citations July 1986 -- June 2003:

C.A.2, 1986. Subsec. (1), coms. (i) and (j) cit. in disc. A bank president operated a large illegal drug business and deposited the proceeds of this business into a correspondent bank when his bank was closed down. The government sued the correspondent bank seeking forfeiture of the accounts as proceeds of a drug transaction. The trial court issued in rem warrants for the arrest of the accounts in question. This court affirmed the issue of the warrants, holding that the government was entitled to use its choice of reasonable accounting methods to trace the flow of drug funds in accounts containing both legally and illegally obtained assets. *United States v. Banco Cafetero Panama*, 797 F.2d 1154, 1159, superseded by statute as stated in 832 F.Supp. 542 (D.N.Y.1993).

C.A.2, 1996. Subsec. (1) quot. in fn. Creditors of produce vendor filed suit in bankruptcy court pursuant to the Perishable Agricultural Commodities Act (PACA) seeking payment out of the proceeds derived from vendor's sale of his store and office units. The bankruptcy court dismissed on various grounds and the district court affirmed, concluding, inter alia, that the units were not part of the PACA trust because vendor acquired them prior to conducting any business with creditors. Vacating and remanding, this court held that a PACA trust arose upon the sale of produce on credit to a produce debtor, that subsequent unpaid sellers became equitable owners of the trust property who joined the general pool of trust beneficiaries, and that the trust, which included all produce-related assets regardless of their origin, ended only when each beneficiary was paid. The court noted that, to prevail on remand, vendor would have to show, among other things, that he did not wrongfully acquire the units with trust assets. *In re Kornblum & Co., Inc.*, 81 F.3d 280, 284.

C.A.2, Bkrcty.App.2000. Coms. (b) and (o) cit. in disc. Chapter 7 trustee sought to avoid certain prepetition transfers from debtor/law firm to creditor/clients as preferences. The bankruptcy court entered judgment against trustee, reasoning that the payments were not preferences because they were made from funds held in trust by debtor for the benefit of creditors. Reversing, this court held, in part, that once creditors here had established a beneficiary-trustee relationship with debtor, they bore the burden of tracing their property to a particular trust res in order to

maintain priority over other unsecured creditors. In re Carrozzella & Richardson, 247 B.R. 595, 599.

C.A.3, 1993. Com. (j) cit. in disc., com. (m) quot. in fn. to conc. and diss. op. A gas pipeline operator in Chapter 11 bankruptcy moved for authority to pay prepetition obligations in order to comply with Federal Energy Regulatory Commission (FERC) tariff orders. The bankruptcy court granted the request in part and the district court affirmed in part. Affirming in part, reversing in part, and remanding, this court held, inter alia, that customer refunds and upstream supplier pre-petition surcharges determined to be held in trust by the debtor so as not to be part of the bankruptcy estate were distributable only in an amount equal to the lowest amount in its general account on a pro rata basis, and the remainder of the obligations would be considered unsecured debt. A concurring and dissenting judge argued that the lowest intermediate balance test should not have been applied to FERC-ordered refunds to limit their pass-through to consumers. In re Columbia Gas Systems Inc., 997 F.2d 1039, 1063, 1066, cert. denied 510 U.S. 1110, 114 S.Ct. 1050, 127 L.Ed.2d 372 (1994).

C.A.4, 1998. Com. (j) cit. in sup. In Chapter 11 bankruptcy action, lenders commenced adversary proceeding to recover escrow funds misappropriated by debtor/closing agent. The district court entered summary judgment for lenders on the ground that they were entitled to an express or constructive trust over their share of debtor's bank account. Affirming, this court held that the funds at issue were not part of the bankruptcy estate because the parties created an express trust in debtor to hold that property for the benefit of specified third parties, and that the amount of lenders' recovery would be determined in accordance with the "lowest intermediate balance" rule. In re Dameron, 155 F.3d 718, 724.

C.A.6, 2002. Com. (m) cit. in disc. Bankruptcy estate trustee sought to avoid debtor attorney's fraudulent transfers from clients' escrow accounts to his commodity account, and bankruptcy court entered judgment for trustee. District court reversed, and this court affirmed, holding, inter alia, that debtor had no "interest in the property" that would subject funds held in escrow to trustee's avoidance power. Under Tennessee law the escrow accounts constituted express trusts and so never entered debtor's estate. When debtor deposited his personal funds into the escrow accounts in an attempt to repay misappropriated funds, he obtained no interest in the trust corpus that would allow trustee to avoid the fraudulent transfers. In re Cannon, 277 F.3d 838, 851.

C.A.7, 1987. Cit. in disc., com. (j) cit. in disc. A creditor sued a debtor's guarantor to recover money lost after the debtor induced the creditor to lend money against worthless security by falsifying its sales records. The district court entered summary judgment for the guarantor, finding that the guarantor had effectively revoked his guaranty as of April 2, 1981, and that payments made by the debtor after that date extinguished the guarantor's liability. The court of appeals vacated and remanded, holding that the district court's application of the FIFO accounting method was inappropriate in this case where the debtor owed \$404,000, paid \$554,000, and borrowed an additional \$407,000, because it discharged the guarantor without reducing the risk to which the creditor was exposed. The court directed the district court to employ either the item-by-item method or the lowest intermediate balance method, whichever more accurately reflected the risk to which the creditor was exposed on April 2, 1981. First Wisconsin Financial Corp. v. Yamaguchi, 812 F.2d 370, 375.

C.A.7, 1992. Cit. but dist. The federal government froze funds in the principal accounts of corporations that manufactured and sold stereo speakers and demanded forfeiture of the sums as criminal proceeds of the corporations' fraudulent business operation. Affirming the district court's granting of summary judgment for the government, this court held that the government was entitled to the entire balance in the accounts, regardless of whether the corporations had become legitimate operators several months before the seizure. The court said that the rules of tracing mingled property did not apply in cases involving fraud in which funds had been shuffled at least in part to disguise their source and noted that even if the fraud had stopped by the time of the seizure, the criminal proceeds far exceeded the sums on deposit at that time. U.S. v. \$448,342.85, 969 F.2d 474, 477.

C.A.9, 1991. Com. (m) cit. in fn. The trustee of a Chapter 7 bankruptcy estate filed a complaint to recover funds transferred by the debtor trade school to the government as an avoidable preference. The debtor had not made all the disputed transfers within the 90-day period before the filing of its bankruptcy petition as required by the Bankruptcy Code for the exercise of the trustee's avoidance powers. The bankruptcy court entered summary judgment for the trustee, holding that the transferred funds were the property of the debtor so that the transfer operated to diminish the funds to be used to pay the bankruptcy creditors. The district court affirmed. Affirming in

part and reversing in part, this court held that the debtor's funds deposited in the government's trust account before the 90-day preference period could not be avoided by the trustee as a preference; however, the transfer of nontrust funds within the 90-day period constituted an avoidable preference under the Bankruptcy Code. In re California Trade Technical Schools, Inc., 923 F.2d 641, 646.

D.Conn.Bkrcty.Ct.1995. Com. (j) cit. in disc. A Chapter 11 debtor and a trustee sued to avoid the transfer of a debtor's payment to a law firm, alleging that law firm's receipt of the sum constituted a fraudulent transfer. Relying on the intermediate balance rule, defendant alleged that plaintiffs could not trace and identify the funds transferred to defendant as debtor's funds. This court granted in part the law firm's motion for summary judgment, but held, inter alia, that a material issue of fact existed as to whose monies were in debtor's bank account, precluding summary judgment on the issue of whether the plaintiffs seeking to impose a constructive trust on money in the account could trace and identify the transferred funds. In re Colmark I Ltd. Partnership, 189 B.R. 253, 256.

D.Conn.Bkrcty.Ct.1999. Com. (b) cit. in disc. Trustee of a Chapter 7 estate of a debtor law firm sued to recover, as alleged preferences, payments that the law firm had made to clients prepetition. This court held that the funds transferred to defendant clients by the debtor within the preference period were impressed with a trust for their benefit. As such, the transfer of those funds was not a transfer of an interest of the debtor in property, and consequently could not form the basis for preference avoidance by plaintiff. In re Carrozzella & Richardson, 237 B.R. 544, 550, reversed 247 B.R. 595 (2d Cir.BAP 2000).

D.Conn.Bkrcty.Ct.2000. Com. (b) cit. in disc. Bankruptcy trustee for debtor law firm brought a series of avoidance actions against parties who received funds from debtor within the preferential transfer "look-back window" of Bankruptcy Code. Defendants claimed to have had a trust relationship with the debtor with respect to the funds. This court denied trustee's motion for summary judgment, holding, inter alia, that fact issues existed as to whether an express trust was created. Assuming that an express trust was created, it was not appropriate that defendants bear the burden of tracing their funds, since by transferring funds back to defendants on request, the debtor-trustee had essentially and presumptively traced the funds for defendants. In re Carrozzella & Richardson, 255 B.R. 267, 275.

N.D.Iowa Bkrcty.Ct.1989. Subsec. (1) cit. in sup. After a debtor deposited \$25,000 in his life insurance policy, declared bankruptcy, and claimed the policy as exempt to its full value, a trustee and two creditors filed objections to the claim of exemption. Sustaining the objections, the court held that, because the debtor intentionally converted cash proceeds of collateral secured to a creditor into life insurance contrary to their agreement, he was not entitled to claim the cash value attributable to the proceeds as exempt. In re Rodemeyer, 99 B.R. 416, 424.

D.Me.Bkrcty.Ct.1995. Com. (j) cit. in disc. Chapter 7 trustee objected to assertion of debtor that his interest in a realty trust was excluded from the bankruptcy estate. The court held, inter alia, that, because the trust was self-settled, its spendthrift transfer restrictions were unenforceable under applicable nonbankruptcy law and debtor's interest in the trust was not protected from involuntary transfer at the behest of his creditors; thus, debtor's beneficial interest in the trust was part of the bankruptcy estate. In re Spenlinhauer, 182 B.R. 361, 363.

E.D.Mich.Bkrcty.Ct.1993. Cit. in disc. Subcontractor filed an adversary proceeding against debtor-contractor, seeking recovery of alleged trust funds that it claimed were not assets of debtor's estate. Denying the claim, the court held that, since subcontractor failed to adequately trace payment by customer to debtor that was intended for subcontractor's benefit to any funds remaining in a commingled bank account of payments held in trust for other subcontractors, the funds were assets of debtor's estate. Matter of Michigan Boiler & Engineering Co., 171 B.R. 565, 573.

E.D.Mo.2003. Coms. (i)-(m) cit. in disc., illus. 20 quot. in fn. Creditor sued bank for a declaratory judgment and asserted claims for conversion, tortious interference with contract, and unjust enrichment, inter alia, alleging that bank's sweeping of funds from debtor's bank account to pay down its line of credit was wrongful because it interfered with plaintiff's first priority security interest in cash proceeds of plaintiff's collateral. This court granted plaintiff's motion for partial summary judgment on conversion claim, holding, inter alia, that, based on equities, judicial authority, and policies inherent in encouraging parties to obtain secured financing, plaintiff could use lowest-intermediate-balance rule to trace its cash proceeds into debtor's bank account; thus, plaintiff's security

interest in proceeds of its inventory collateral properly attached. *General Electric Capital Corp. v. Union Planters Bank, N.A.*, 290 B.R. 676, 682.

E.D.N.Y.1993. Subsec. (1), com. (j) cit. in disc. The government sued for forfeiture of all funds on deposit in various bank accounts and properly traceable to them, alleging that this money had been derived from money laundering operations following illegal drug transactions. This court, denying one claimant's motion for summary judgment but granting another claimant's motion in part, held, inter alia, that, in seeking to forfeit money allegedly derived from money laundering, the government was not required to prove that the funds subject to forfeiture were the identical funds involved in the money laundering, so that the claimants could not use a "zeroing out" argument to immunize substitute funds from seizure. If, however, said the court, the forfeiture was predicated on funds being proceeds from, or traceable to, narcotics violations and if the seized account had "zeroed out" after the violations, funds in the account were no longer subject to forfeiture. *U.S. v. All Funds Presently on Deposit*, 832 F.Supp. 542, 552.

S.D.N.Y.Bkrcty.Ct.1987. Com. (l) cit. in disc. An unincorporated group of insurers sought to reclaim monies paid to a debtor/owner of a vessel pursuant to an insurance agreement after the debtor recovered additional funds for the vessel from the Panama Canal Commission. This court found for the plaintiffs, holding that they were entitled to the payment received from the commission through the doctrine of constructive trust. However, the court refused to create an administrative priority for the plaintiffs, since the funds held in trust were disbursed post-petition and could not be traced. In re *U.S. Lines, Inc.*, 79 B.R. 542, 545, 546.

D.S.D.1996. Cit. in headnotes, com. (j) cit. in disc. Cattle seller sued bank for conversion after bank set off funds from cattle buyer's account to satisfy buyer's debt to it, then dishonored two checks he wrote seller. When the jury returned a \$216,000 verdict for seller, bank moved for judgment as a matter of law arguing, among other things, that the lowest intermediate balance rule should be used in order to prove exactly which funds were used to set off buyer's debt. Denying the motion, the court held, inter alia, that it would not apply the lowest intermediate balance rule where bank raised the issue for the first time on appeal. Moreover, even if the issue were timely raised, bank presented no evidence tending to show that the rule was followed in this jurisdiction. *Meyer v. Norwest Bank Iowa, Nat. Ass'n*, 924 F.Supp. 964, 966, 970, reversed 112 F.3d 946 (8th Cir.1997).

Cal.App.1993. Coms. (j) and (k) cit. in disc. Third parties claimed interest in joint account of debtor and creditor that had a perfected security interest in collateral, contending that debtor so commingled proceeds from sale of collateral with other funds that they were not identifiable. The trial court held that third parties had right to levy against funds and that their claims had priority over creditor's. This court denied creditor's petition for writ of mandate, stating that debtor did not deposit proceeds from sale of collateral into joint account directly but wrote checks against its general operating account. It explained that at the time debtor wrote the checks, there were no proceeds from sales of collateral in the general operating account; those funds, together with any other funds deposited had been used to reduce the general operating account's deficit. It held that debtor deposited funds in general operating account to reduce that account's overdraft balance and that bank honored overdrafts by advancing its own funds; therefore funds deposited into joint account were not proceeds of any sales of collateral but were funds loaned by bank. *Chrysler Credit. Corp. v. Superior Court*, 17 Cal.App.4th 1303, 22 Cal.Rptr.2d 37, 45.

Ky.App.1992. Quot. in sup., com. (o) quot. in sup. Creditors of a car dealership filed a declaratory judgment action seeking to determine priorities of distribution of the proceeds from the sale of the dealership's assets. The trial court imposed constructive trusts in favor of certain creditors for payments the dealership never remitted to them, and held that tax liens did not have priority over the trusts because the trusts' proceeds were not property in the dealership's possession subject to the liens. Reversing and remanding, this court held that the trial court erred when it did not require the unremitted payments to be traced into specific assets of the dealership before imposing the constructive trusts. On remand the court was to take proof as to the tracing of all misappropriated funds for which a constructive trust was to be imposed, and the tax liens were to have priority over the constructive trusts because the trusts did not come into existence until created by the trial court. *Cabinet for Human Res. v. Security of Am.*, 834 S.W.2d 176, 180.

Me.1994. Com. (j) cit. in disc. and in ftn., com. (m) cit. in ftn. but dist., com. (n) cit. in sup.; illus. 20-22 cit. in

ftn., illus. 28 and 29 cit. in sup. A secured creditor sued a bank for conversion, alleging wrongful setoff of funds deposited in a commingled checking account to satisfy the bank's own secured loan. Vacating the trial court's grant of summary judgment for plaintiff that awarded damages based on the "lowest intermediate balance" rule and remanding with directions to enter judgment for plaintiff for a lesser amount, this court held that, as both plaintiff and defendant had a security interest in the account's proceeds and there was no priority dispute between them, the proper measure of damages was through application of the rule on a pro rata basis, notwithstanding plaintiff's contention that this assumed that the parties were equally innocent. Recognition of both creditors' interests required continuous prorating of the account balance to prevent one creditor from receiving a windfall. *Bombardier Capital v. Key Bank of Maine*, 639 A.2d 1065, 1067, 1068.

Mont.1993. Subsec. (1) cit. in sup., com. (j) quot. in sup. As a loan condition, borrower secured obligation to bank with financial guarantee bond issued by insurer. Borrower gave insurer a \$250,000 retained deposit, which was placed in insurer's general operating account. The court ordered defendant into liquidation in 1985, and borrower filed claim with liquidator for retained deposit, asserting preference over other creditors' claims. The trial court appointed a referee, who recommended that plaintiff's deposit be given Class 4 priority treatment under state law. The trial court adopted referee's recommendations and held that plaintiff's trust property was extinguished. This court affirmed, holding that when defendant's general operating account reached the lowest intermediate balance in 1984, plaintiff's trust funds in the account were dissipated and its right to preferential claim against defendant was extinguished as well. It noted that plaintiff did not show that its funds were commingled with or used to purchase any other assets. *Bennett v. Glacier General Assur. Co.*, 259 Mont. 430, 857 P.2d 683, 685-687.

Okl.App.1990. Cit. in sup. §§ 202-213. After making a demand on cotrustees, who were also residuary beneficiaries, for an accounting and distribution of trust monies and receiving no response, the primary beneficiaries of a testamentary trust sued the cotrustees for an accounting of trust assets, their removal as cotrustees, appointment of a new trustee, restitution of fees wrongfully paid by the cotrustees to themselves, and actual and punitive damages for fraud and gross negligence. The trial court found that the defendants had embezzled and converted trust property to their own use and had paid themselves unreasonable fees. Moreover, they had intentionally misinformed one plaintiff regarding the existence of the trust and his status and/or rights as a beneficiary thereof. The court removed the defendants, appointed a successor, ordered restitution to the trust, and awarded actual and punitive damages against the defendants. Affirming, this court held that there was no reversible error of law and that the trial court's findings of fact were supported by sufficient competent evidence and noted that the defendants' profession of good faith and/or reliance on advice of counsel did not constitute a defense to the action. *Robinson v. Kirbie*, 793 P.2d 315, 318.

(1959)

REST 2d TRUSTS § 202

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