

**UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA**

In Re:
Douglas M. Hess,
Debtor

**Bky. No. 98-31761
Chapter 7 Case**

John Hoehne, Norm Merz,
and Robert Fait,
Plaintiffs,
v.
Douglas M. Hess,
Defendant.

Adv. No. 98-3173

**AMENDED
MEMORANDUM ORDER**

This matter is before the Court on its own initiative, pursuant to Rule 60(a) of the Federal Rules of Civil Procedure, to correct a clerical error in the Court's May 17, 1999 memorandum order in this matter. This Amended Memorandum Order issued this date makes non-dispositive changes in the Court's earlier order and does not affect the outcome of the case. Specifically, this Order reinserts a portion of the analysis of the earlier version inadvertently and mistakenly deleted from the final draft of the May 17, 1999 memorandum order beginning on page 8 thereof at line 2.

This matter came before the Court on the Plaintiffs' motion for summary judgment; Defendant's cross motion for summary judgment; Defendant's motion for partial dismissal for failure to plead fraud with particularity; or, in the alternative, Defendant's motion for dismissal for failure to state a claim under Rule 12(b) of the Federal Rules of Civil Procedure. Michael S. Dietz appeared for the Plaintiffs, and William I. Kampf appeared for the Defendant. This matter is a core proceeding and the Court has jurisdiction pursuant to 28 U.S.C. § 157 and 1334. The petition commencing this Chapter 7 case was filed on March 23, 1998 and the case is now

pending in this court.

Based upon all of the files, memoranda, and proceedings herein, and based upon the arguments of counsel, the Court makes the following **ORDER** pursuant to the Federal and Local Rules of Bankruptcy:

The Plaintiffs' Complaint seeks nondischargeability under 11 U.S.C. § 523(a) (2)(A), (4), and (6), but Plaintiffs seek summary judgment under 11 U.S.C. § 523(a)(4) alone. The Plaintiffs rely upon the findings of fact and conclusions of law contained in "Findings of Fact, Conclusions of Law, and Order for Judgment" entered on October 21, 1997 by the Honorable Gerald W. Ring, in Olmsted County District Court, Minnesota, in litigation styled: John Hoehne, Norm Mertz, and, Robert Fait, Plaintiffs, v. Douglas Hess, Defendant, Court File No. C9913657. The Defendant seeks summary judgment on all counts, alleging that the state court record is insufficient to support a finding of nondischargeability under 11 U.S.C. § 523(a). The Defendant argues that under the uncontroverted facts, as determined by the state court, it is impossible for the Plaintiff to establish any theory under which nondischargeability would be appropriate. In the alternative, the Defendant seeks a partial dismissal of the Plaintiffs' Complaint for failure to plead fraud with particularity.

I. Facts

The business relationship underlying this dispute began in May of 1990. The Defendant, Mr. Hess, phoned one of the Plaintiffs, John Hoehne, with an investment opportunity involving certain Federal Deposit Insurance Corporation (FDIC) loans. Using funds from Mr. Hoehne, Mr. Hess would purchase at auction the right to collect certain FDIC loans.

After Mr. Hess's successful bid on a loan package, Mr. Hoehne and Mr. Hess paid FDIC

\$460,000 on May 9, 1990. Only after the \$460,000 payment to FDIC did Mr. Hess inform Mr. Hoehne that the conditions of the FDIC sale required payment of an additional \$4,140,000 by June 1, 1990, or they would lose their deposit. Mr. Hoehne invested additional funds, and along with Mr. Hess, he convinced two additional investors, Messrs. Merz, and Fait, to invest in the venture. Eventually the Plaintiffs in this action: Messrs. Hoehne, Merz, and Fait, collected and invested the additional \$4,140,000 needed to complete the transaction with FDIC and prevent forfeiture of the initial investment.

Despite the significant sum of money involved, the parties never reduced their agreement to writing. Mr. Hess successfully collected on a number of the purchased loans and on December 11, 1991 Messrs. Hoehne, Merz, and Fait brought a state court action (Case No. C9-91-3657, Olmstead County District Court, Minnesota) against Mr. Hess, seeking to recover their share of profits¹. After protracted state court litigation the matter was largely resolved² by the “Findings

¹The state court’s findings do not specify that the agreement of the parties first required Mr. Hess to return the Plaintiffs’ investment (with interest). In arguments before this Court, however, both sides concede that the profits still owed, and reflected in the \$1,106,807.75 judgment, do not include the return of the initial investments of the Plaintiffs. It is undisputed that those amounts have already been returned with an agreed upon payment of interest.

²In addition to Judge Ring’s “Findings of Fact, Conclusions of Law, and Order for Judgment,” a Memorandum was issued which detailed the court’s methodology in calculating damages. *Aff. of Nathan T. Riordan, Ex. 2*. The memorandum specifies that the \$1,106,807.75 judgment does not include the prevailing parties’ share of the \$68,834 of interest earned on the profits. *Id.* p. 2.

Normally if a party breaches a contract for the payment of money, the aggrieved party is entitled to interest from the date the payment was due. . . . Apparently there was no agreement as to the date the payments should have been made. In the absence of an agreement, the court can include a reasonable date. Thirty days after the collections were substantially completed would be a reasonable payment date. . . . I do not have facts which allow me to determine that date at this time. *Id.* p. 2-3.

of Fact, Conclusions of Law, and Order for Judgment” issued by the Honorable Gerald W. Ring, on October 21, 1997. Aff. of Nathan T. Riordan in supp. Of Def.’s Mot. For . . .Summ. J., Ex. 1. Judgment was entered against Mr. Hess on December 1, 1997 in the amount of \$1,106,807.75. Id., Ex. 3.

The state court determined that the parties’ agreement allowed Mr. Hess complete control of the collection of loans and day to day operation of the venture. Under this agreement Mr. Hess was entitled to a salary, or administrative expenses, of “\$5000 per month per million to be collected, in an amount not to exceed \$750,000 and a new truck. The parties stipulated that the value of the truck is \$7000.” Id., Ex. 1. Mr. Hess also borrowed additional funds to finance the venture’s ongoing operation. The state court calculated profits by subtracting the \$757,000 of administrative expenses, and the interest paid by Mr. Hess on the ventures’ operating loans, from the proceeds or profits remaining after the return of the initial investments with interest.

According to the state court findings: “The profit from the loan packages in question was \$1,483,077.” Id., Ex. 1, #7. The state court also determined that the parties’ contract called on them to share profits “on an equal percentage basis, after deduction of expenses[.]” Id., #1. The district court ordered judgement for the Plaintiffs in the amount of “\$1,106,807.75, plus interest from a date to be determined later.” Id.

II. Analysis

Summary Judgment Standard

Rule 7056 of the Federal Rules of Bankruptcy Procedure provides that “Rule 56 Civ. P. applies in adversary proceedings.” Rule 7056, F.R. Bankr. P. Summary judgment “shall be rendered forthwith if . . . there is no genuine issue as to any material fact and that the moving

party is entitled to a judgment as a matter of law.” Fed. R. Civ. P. 56(c).

In determining summary judgment “the [c]ourt views the fact in a light most favorable to the nonmoving party and allows that party the benefit of all reasonable inferences to be drawn from that evidence.” Prudential Ins. Co. v. Hinkel, 121 F.3d 364, 366 (8th Cir. 1997). “In making this determination, the function of the presiding court is not to weigh evidence and to make credibility determinations, or to attempt to determine the truth of the matter, but is, rather, solely ‘to determine whether there is a genuine issue for trial.’” Ries v. Wintz Properties (in re Wintz Companies), Nos. 98-6085/6086/6087MN, (8th Cir. March 17, 1999), quoting Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 250 (1986).

To evaluate summary judgment in a 11 U.S.C. § 523(a) nondischargeability action, the Court is also mindful that “[t]he Statutory exceptions to discharge in bankruptcy are narrowly construed, and the creditor opposing discharge must prove the debt falls within an exception to discharge.” Werner v. Hoffman, 5 F.3d 1170 at 1172 (8th Cir. 1993) citing Belfry v. Cardoza (In re Belfry), 862 F.2d 661, 662 (8th Cir. 1988).

11 U.S.C. § 523(a)(4)

Fraud Or Defalcation While Acting In A Fiduciary Capacity.

This Code provision precludes a discharge for any debt “for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny[.]” The Plaintiffs claim that the nature of the Defendant’s relationship to the Plaintiffs created an expressed trust, and that Mr. Hess breached his fiduciary duty to the other investors by failing to pay over their share of the profits. The Defendant argues that under 11 U.S.C. § 523(a)(4) no fiduciary duty can exist because there was no writing between the parties to create the required express or technical trust.

In order to prevail under any section of 11 U.S.C. §523(a) the plaintiff must establish the elements of nondischargeability by a preponderance of the evidence. Grogan v. Garner, 111 S.Ct. 654 at 655 (1991).

Not all fiduciary relationships meet the nondischargeability standard of § 523(a)(4). In § 523(a)(4) proceedings “[t]he concept of ‘fiduciary capacity’ is limited to express or technical trusts, not those implied by law.” United American Insurance Company, v. Koelfgen (In re Koelfgen), 87 B.R. 993 (Bankr. D. Minn. 1988). The Plaintiffs’ state court complaint asserts: “[a] verbal agreement was reached that each plaintiff would be entitled to an equivalent unit of profits . . . after money investors were repaid their principal plus accrued interest, and Hess would also have an equivalent unit.” Aff. of Nathan T. Riordan, Ex. 4, XIV.

Whether an expressed or technical trust can exist in the absence of a writing is a threshold issue. The holding in United American Insurance Co. v. Koelfgen describes a writing requirement:

Express or technical trusts are formed by direct and positive acts of both parties ***manifested by some instrument in writing***, whether by deed, will, or otherwise. United American Insurance Co. v. Koelfgen (In re Koelfgen), 87 B.R. 993 at 996 (Bankr. D. Minn. 1988) citing Morgan v. American Fidelity Fire Ins. Co., 210 F.2d 53 (8th Cir. 1954) (emphasis added).

The Plaintiffs argue that the requirement for a writing contained in both Koelfgen and Morgan v. American Fidelity Fire Ins is dicta. In Koelfgen the court’s decision of dischargeability rested on the interpretation of a written contract. Id. The 8th Circuit decision in Morgan v. American Fidelity Fire Ins. was again based on interpreting a written agreement between the parties. Morgan v. American Fidelity Fire Ins. Co., 210 F.2d 53 (8th Cir. 1954).

Both cases begin their analysis with a written agreement. Without those written

agreements the decisions by the Koelfgen and Morgan courts would have been substantively different. Neither decision supports the Plaintiffs' proposition that § 523(a)(4) nondischargeability "while acting in a fiduciary capacity" can be granted by this Court, absent a writing that creates an express or technical trust.

The Plaintiffs suggest that any requirement for a writing was overturned by the 8th Circuit's decision in Tudor Oaks Limited Partnership v. Cochrane (In re Cochrane), 124 F.3d 978 (8th Cir. 1997). In Cochrane, an attorney usurped business opportunities and profits of a client. The decision of nondischargeability relied on the special duty owed a client by an attorney, not the underlying business agreements of the various entities involved.

[A]n attorney-client relationship is the type of relationship for which the attorney's breach of fiduciary duties to the client may give rise to a finding of "defalcation" within the meaning of § 523(a)(4). Id. at 984.

In light of this holding, it was unnecessary for the 8th Circuit to recite which documents reviewed in the underlying state court actions might have supported the court's decision.³

Courts must review fiduciary duties contained in written agreements under the narrow standard on nondischargeability of § 523(a)(4), but courts may not impose nondischargeability in a business context for breach of a fiduciary duty under § 523(a)(4), absent a written agreement. Cochrane does not change this requirement. Unlike Cochrane, Mr. Hess was not the Plaintiffs' attorney and the Plaintiffs fail to propose any other special relationship which could give rise to a special fiduciary relationship under 11 U.S.C. § 523(a)(4). The Plaintiffs' failure to suggest any

³A review of the Minnesota Court of Appeals decision which liquidated the damages in the Cochrane nondischargeability action suggests no shortage of written documentation. See S.B. McLaughlin & Co., Ltd., et al. v. Cochrane, C4-92-2081, slip op. at 2-3, 1993 WL 231672 (Minn.Ct.App. June 29, 1993).

type of special relationship which could lead to a fiduciary duty (absent a written contract) means summary judgment on breach of fiduciary duty is appropriate for the Defendant.

Larceny.

The Plaintiffs could still prevail under § 523(a)(4) if they can establish that Mr. Hess was guilty of larceny or embezzlement. “Larceny is the wrongful taking and carrying away of property of another with intent to convert said property to one's use without the consent of the owner.” Werner v. Hofmann (In re Hofmann), 144 B.R. 144 at 464 (Bankr. D. N.D. 1992). But, larceny will not lie where the alleged wrongdoer lawfully took possession of the property. See Werner v. Hofman, where “the larceny exception could not apply because the Hoffman’s original possession of the cattle was lawful.” Werner v. Hofman, 5 F.3d 1170 at 1172 (8th Cir. 1993). The undisputed facts here indicate that Mr. Hess’ initial possession of the profits in this venture was legal. The judgment which the Plaintiffs seek to enforce against Mr. Hess is based on profits earned by Mr. Hess, utilizing the funds of the Plaintiffs. Whatever the nature of the parties’ relationship, Mr. Hess was solely responsible for activities which gave rise to the profits: “Hoehne, Merz, and Fait would take no control of, nor have any say or responsibility in, the collection efforts of Hess Investments.” Pl.’s Mem. In Supp. Of Mot. For Summ. J., Ex. D., XVI. Mr. Hess had lawful possession of the profits in this undertaking, even though he later failed to pay over those profits. His lawful possession of the funds in question preclude a finding of larceny within the 11 U.S.C. § 523(a)(4) context.

Embezzlement.

The Plaintiffs’ only remaining claim for nondischargeability under 11 U.S.C. § 523(a)(4) is for embezzlement. “The elements of embezzlement are 1) appropriation of funds by debtor for his

benefit, and 2) appropriation of funds with fraudulent intent or deceit.” Koelfgen v. United American Insurance Company (In re Koelfgen), 87 B.R. 993 at 997 (Bankr. D. Minn. 1988).

Mr. Hess argues that the Plaintiffs’ judgment is based on a creditor/debtor relationship, and argues that 523(a)(4) nondischargeability for embezzlement is unavailable between creditors and debtors. Mr. Hess cites as authority In re Koelfgen, where the court did conclude the parties had a creditor/debtor relationship: “Where the parties’ conduct indicates a debtor/creditor relationship, funds that come into the hands of the debtor belong to him and any subsequent use of them is not embezzlement.” Koelfgen v. United American Insurance Company (In re Koelfgen), 87 B.R. 993 at 998 (Bankr. D. Minn. 1988) quoting Storms, 28 B.R. at 765.

But the record before this Court does not allow a summary conclusion that the outstanding judgment arose from a creditor-debtor transaction. “The jury found that the parties had agreed to share profits after payment of certain expenses[,]” suggesting a partnership relationship. Aff. of Nathan T. Riordan . . . Ex. 2, p. 2.

Summary judgment on embezzlement is inappropriate here because the nature of the parties’ business relationship is in doubt. If a creditor-debtor relationship, it seems likely that the Defendant will prevail, since the Defendant would have owned the profits and could not have embezzled his own property. See Belfry v. Cardoza (In re Belfry), 862 F.2d 661 at 662 (8th Cir. 1988); see also Vannelli v. Barr (In re Barr), Ch. 7 Case No. 98-32872, Adv. No. 98-3235, (Bankr. D. Minn. April 30, 1999). But if a partnership, the profits were owned by the partnership, not by the Defendant, and embezzlement would lie if he fraudulently appropriated them to his own use.

11 U.S.C. § 523(a)(2)(A)

Section 523(a)(2)(A) provides an exception to discharge:

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
(A) false pretenses, a false representation, or actual fraud. . . .
11 U.S.C. § 523(a)(2)(A).

Proving false pretenses, false representations, or actual fraud requires proof of five elements:

1. The debtor made false representations;
2. The debtor knew the representations to be false at the time the debtor made them;
3. The debtor made the representations with the intention and purpose of deceiving the creditor;
4. The creditor actually relied on the debtor's representations; and
5. The creditor sustained the alleged injury as the proximate result of the making of the representations. Check Control, Inc. v. Anderson (In re Anderson), 181 B.R. 943 at 948 (Bankr. D. Minn. 1995).

The Defendant seeks summary judgment on this claim by arguing that no damages exist for the alleged fraud because the Plaintiffs' investments were returned in full. The Plaintiffs' Complaint alleges fraud under Count II, claiming: "Hess knew, but did not disclose to Hoehne that the substantial deposit would be forfeited if the balance of the purchase price was not tendered within a very short time." Compl. #11. During the hearing on these motions, the Plaintiffs argued that these facts are a sufficient basis for avoiding summary judgment on their fraud claim because Mr. Hess fraudulently induced the plaintiffs to invest the initial deposit of \$460,000; once induced to make the initial investment they were "forced" to invest the additional

\$4,140,000, or lose their initial investment.

The Plaintiffs' claims might have merit in a case to recover any or all of the funds originally invested. But the Plaintiffs concede that all money invested with Mr. Hess was returned with interest. Instead they seek to recover their share of profits earned on the venture. Accordingly, the amount invested is irrelevant to determining 11 U.S.C. § 523(a)(2)(A) nondischargeability in this case. The Plaintiffs have no damages arising from the purported fraudulent act and cannot establish the fifth element of nondischargeable fraud: "the creditor sustained the alleged injury as the proximate result of the making of the representations." 181 B.R. at 948. The Plaintiffs' failure to either plead or argue the damages required to sustain a finding of fraudulent misrepresentation is fatal to this count of their Complaint. The Defendant's motion for summary judgment on Count II, nondischargeability under 11 U.S.C. § 523(a)(2) should be granted.⁴

11 U.S.C. § 523(a)(6)

The Defendant seeks summary judgment on the Plaintiffs' claim of nondischargeability for willful and malicious injury. Under 11 U.S.C. 523(a)(6) discharge is denied for any debt "for willful and malicious injury by the debtor to another entity or the property of another entity." 11 U.S. C. § 523(a)(6). "The word "willful" in (a)(6) modifies the word 'injury,' indicating that nondischargeability takes a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury." Kawaauhau v. Geiger, 118 S.Ct. 974 at 977 (1998).

⁴Since summary judgment is granted on this portion of the Defendant's motion, the Court declines to address the Defendant's motion for partial dismissal for failure to plead fraud with particularity.

Defendant argues that the underlying state court judgment is for breach of contract⁵, and that the Kawaaauhau court specifically excluded knowing breaches of contract from § 523(a)(6) nondischargeability. 118 S. Ct. at 977. However, different determinations about when the Plaintiffs' rights ripened into an identifiable interest in the profits, and the nature of their underlying agreement, could implicate obligations for the Defendant, and rights of the Plaintiffs, to support a finding of nondischargeability for willful and malicious injury. If the profits were owned by a partnership, the Defendant's conduct in failure to pay them over might well have been much more egregious than simple breach of contract. See Universal Pontiac-Buick-GMC Truck Inc. v. Routson (In re Routson), 160 B.R. 595, 602 (Bankr. D. Minn. 1993) ("Wrongful conversion ... is covered by § 523(a)(6)").

The character and details of the underlying business relationship are critical to determination of the 11 U.S.C. § 523(a)(6) action. Absent a final determination of the character and timing of this business relationship, summary judgment is inappropriate on this count.

⁵See the discussion under embezzlement above. The state court findings, while describing Mr. Hess' breach of contract, do not specify the nature of the relationship between the parties. Although Mr. Hess argues for a creditor-debtor relationship, the language of the state court's memorandum suggests the parties entered into a partnership: "The jury found that the parties had agreed to share profits after payment of certain expenses." Def. Ex. 2, p. 2.

III.

Based on the foregoing, it is hereby **ORDERED**:

- 1) Defendant's motion for summary judgment on Count I, nondischargeability under 11 U.S.C. §523(a)(4), for fraud or defalcation while acting in a fiduciary capacity, is granted;
- 2) Defendant's motion for summary judgment on Count I, nondischargeability under 11 U.S.C. §523(a)(4), for larceny, is granted;
- 3) Defendant's motion for summary judgment on Count I, nondischargeability under 11 U.S.C. §523(a)(4), for embezzlement, is denied;
- 4) Plaintiff's motion for summary judgment on Count I is denied;
- 5) Defendant's motion for summary judgment on Count II, nondischargeability under 11 U.S.C. §523(a)(2)(A), is granted;
- 6) Defendant's motion for summary judgment on Count III, nondischargeability under 11 U.S.C. §523(a)(6), is denied;
- 7) The case will proceed to trial to determine nondischargeability under 11 U.S.C. § 523(a)(4), for embezzlement, and, 11 U.S.C. § 523(a)(6), for willful and malicious injury.

LET JUDGMENT BE ENTERED ACCORDINGLY.

Dated: June 7, 1999.

By the Court:

/s/ Dennis D. O'Brien
Dennis D. O'Brien
Chief U.S. Bankruptcy Judge