UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA

In re:

ROBERT W. DYGERT, BKY 98-45925

Debtor.

DAVID V. MEYER; GERALDINE A. MEYER; JAMES F. MURPHY; JAMES F. MURPHY AS CUSTODIAN FOR TIMOTHY J. MURPHY; PAMELA A. MURPHY; THOMAS A. MURPHY; IRENE N. WILSON; STEVEN E. WILSON; and WENDELL E. WILSON ADV 98-4363

Plaintiffs,

-v.-

ROBERT W. DYGERT,

Defendant.

FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER FOR SUMMARY JUDGMENT

At Minneapolis, Minnesota, May 11, 2000.

The present matter came before the court on a motion of the Plaintiffs for summary judgment. John Stoebner and David Harbeck appeared on behalf of the Plaintiffs. Edward Bergquist appeared on behalf of the Defendant. Based upon the files and records of the proceeding, the affidavits, and the arguments of counsel, the court makes the following:

FINDINGS OF UNDISPUTED FACT

1. This adversary proceeding stems from the failure of a business known as Organic Conversion Corporation ("OCC"), which filed a Chapter 11 bankruptcy petition in July of 1998. According to its mission statement, OCC is a manufacturing and sales organization serving the organic waste disposal needs of stock yards and municipalities. More specifically, OCC was in the business of composting manure and bagging various soil products for the lawn and garden industry. OCC was incorporated in 1965, but the management group at the time of the bankruptcy did not come into control until 1974. Debtor-Defendant Robert W. Dygert ("Dygert") was one of the incorporators of OCC and also part of the group that later bought out the company.

2. Dygert graduated from law school in 1938 and held a license to practice law until 1999 when it was suspended for failure to comply with the continuing legal education requirement. From the late 1970s until 1986, Dygert practiced law in a partnership with his son Jerry. From 1986 until 1988, he was a partner in a firm known as Dygert and Wise. Beginning July 1, 1988, Dygert left the practice of law to concentrate full-time on the business of OCC.

3. During the relevant time periods, Dygert's family owned all of the OCC stock. Dygert's wife, Kathryn, and son-

in-law, Kurt H. Jensen, each owned 47% of the stock. Dygert's son, Jerry, owned the remaining 6%. At the time of the bankruptcy, Kurt Jensen served as President and C.E.O. of the company. Dygert's grandson, Kurt A. Jensen (known as Andy) was the Vice President and Secretary.

4. Although Dygert no longer owned stock in OCC after 1988, he was still significantly involved in the operations of the business. For a time he was the corporate secretary, and in that capacity he was responsible for preparing the corporate minutes. He was also a member of the board of directors until 1994, but he maintains that in later years he did not attend many meetings of the board because the other members ran the business. He also served as corporate attorney from the late 1980s until the time of the bankruptcy filing. In that position, he oversaw collection activities, suits against competitors, and various nuisance claims. His other duties included building relationships with state fertilizer control officials, attending meetings of the American Association of Plant Food Control Officials, and supervising the testing of products.

5. After 1994, Dygert was no longer active in the day-to-day management of the company. However, he continued to pursue his primary responsibility, which was to ensure that

adequate money was coming into the business to finance operations. The primary vehicle for obtaining sufficient financing was through the solicitation of investments known as Junior Mortgage Notes. The investors were generally friends of Dygert's family and their relatives. In total, approximately $6.1 million was invested through the Junior Mortgage Note program. As part of his role, Dygert reviewed the financial information of the company on a regular basis to determine whether to solicit more investments. Because of this duty, Dygert was intimately familiar with both the assets and liabilities of OCC.

6. The Plaintiffs in this case, David V. Meyer, Geraldine A. Meyer, James F. Murphy, James F. Murphy as custodian for Timothy J. Murphy, Pamela A. Murphy, Thomas A. Murphy, Irene N. Wilson, Steven E. Wilson, and Wendell E. Wilson ("Plaintiffs"), were all individuals who invested in the Junior Mortgage Notes. As an attorney, Dygert or his law firm had represented both Plaintiff David Meyer and Plaintiff Irene Wilson. After Dygert left the practice, Dygert's son Jerry continued to represent Plaintiffs David and Geraldine Meyer, Thomas Murphy, Irene Wilson, and Steven Wilson.

7. The Plaintiffs' Notes generally contained identical terms, including a statement that the notes would be secured

by a junior mortgage upon the real estate, machinery, equipment, inventory or work in process, and finished goods and supplies of OCC. Such mortgage would be subordinate only to existing or future bank loans. Each of the Notes also contained Dygert's personal guarantee. Based upon the Notes in the record before the court, the following chart summarizes the investments made by each of the Plaintiffs and the particular terms of each note.

Date	Investor	Amount	Interest	Date Due
3/7/96	David and Geraldine Meyer	$10,000	12%/10%[1]	30 days notice
2/25/98	James F. Murphy as custodian for Timothy J. Murphy	$2,500	12%/10%	60 days notice
9/20/88	James F. Murphy	$2,500	12.5%	30 days notice
1/1/96	James F. Murphy and Pamela A. Murphy	$5,000	12%/10%	30 days notice
12/30/87	Margaret E. Murphy and Thomas A. Murphy	$10,000	12.5%	30 days notice
2/21/89	Margaret E. Murphy and Thomas A. Murphy	$10,000	15%	8/21/89

[1] Notes with this designation paid 12% interest for the first six months and 10% thereafter.

8/21/89	Margaret E. Murphy and Thomas A. Murphy	$10,750	15%	8/21/90
8/21/90	Margaret E. Murphy and Thomas A. Murphy	$12,432.97	12.5%	30 days notice
12/4/90	Margaret E. Murphy and Thomas A. Murphy	$6,000	12.5%	30 days notice
1/17/92	Margaret E. Murphy and Thomas A. Murphy	$5,000	12.5%	30 days notice
11/23/93	Margaret E. Murphy and Thomas A. Murphy	$10,000	10%	30 days notice
9/25/97	Thomas A. Murphy	$5,000	12%/10%	60 days notice
2/27/98	Thomas A. Murphy	$5,000	12%/10%	60 days notice
11/2/76	Irene Wilson	$15,000	10%	30 days notice
1/3/92	Irene Wilson	$48,800	10%	30 days notice
2/4/92	Irene Wilson	$12,500	12.5%	30 days notice
10/26/92	Steven Wilson	$5,000	10%	30 days notice
9/8/93	Wendell Wilson	$5,000	10%	30 days notice

8. Prior to each investment by the Plaintiffs, Dygert would discuss with them what he perceived to be the positive aspects of the company, but never discussed any negative aspects or any risk associated with the investments.

9. According to the affidavits submitted in connection with the motion for summary judgment, the Plaintiffs were owed the following amounts at the time of OCC's bankruptcy: (1) David V. Meyer and Geraldine A. Meyer, $12,368.58 plus interest; (2) James F. Murphy and Pamela A. Murphy, $13,312.01 plus interest; (3) James F. Murphy as custodian for Timothy J. Murphy, $2,527.95 plus interest; (4) Thomas A. Murphy, $106,180.08 plus interest; (5) Irene N. Wilson, $67,845.82 plus interest; (6) Steven E. Wilson, $2,367.83 plus interest; and (7) Wendell E. Wilson, $5,000 plus interest. In his response, Dygert did not dispute the amounts owed as claimed by the Plaintiffs.[2]

10. Dygert provided the Plaintiffs and other Noteholders with written financial information about the company on a quarterly basis. This information generally only disclosed assets, sales, and profit before taxes and interest payments on the ever-increasing debt load. Plaintiffs received no information regarding the liabilities of the company including the full extent of the other outstanding Junior Mortgage

[2] However, Dygert does dispute that these amounts coincide with the Plaintiffs' actual damages. He argues that Plaintiffs will receive a substantial payment on their claims through OCC's Chapter 11 plan. Even if this is true, it does not relieve Dygert of his liability. If Plaintiffs recover any amount of their claims from Dygert as guarantor, he would merely be subrogated to their treatment under the plan. 11 U.S.C. § 509 (1994).

Notes. Indeed, at one point, Dygert even prepared a so-called "balance sheet" that only portrayed the assets of the company.

11. Dygert stated that he made the decision to not give complete financial statements, even after directly requested by some of the Plaintiffs, because he was afraid it would look too much like a prospectus for unregistered securities. He admitted that knowledge regarding liabilities would be important in evaluating the financial condition of a company. However, Dygert maintained that he always believed there was, in fact, no risk to the investments because he thought OCC was financially viable right up until the bankruptcy filing.

12. The quarterly reports contained in the record provided the following information to the Noteholders:

a. In January, 1990, Dygert sent a letter to the Noteholders announcing growth under the current management. It showed steadily increasing net sales and book value of assets for each year from 1975 to 1989. It provided no information about liabilities or profitability.

b. In a letter dated July 1, 1996, Dygert again boasted about the continuing growth of the company. The letter also noted a temporary cash flow problem due to the increased sales.

c. The letter of January 1997 reported further growth in sales of about 10% over the previous year and predicted an increase in profitability.

d. In July 1997, Dygert announced in his report to the Noteholders that sales had again increased as expected and made other announcements regarding new employees, a new plant, and new customers.

e. The August 20, 1997 letter heralded a 15% increase in sales. It further explained that gross sales, at $5,800,000, were 50% higher than three years before and that bottom line profit had improved. This letter included graphs that showed the increase in sales and value of assets since 1975.

f. The letter dated October 1, 1997, declared a sales volume of $5.9 million for the fiscal year, up from $5.1 million the year before. It further stated that net profit after all expenses including interest was double the amount from the prior year. Dygert has specifically admitted that the latter statement was untrue. While Dygert submits in his affidavit that not all of the investors received this particular letter, he testified at his deposition that all of the Plaintiffs received identical letters.

g. The November 12, 1997, letter provided a chart showing a steady increase in sales and assets since 1975. It

also discussed the imminent availability of a new facility that would help decrease the cost of production.

h. On January 1, 1998, Dygert sent a letter announcing the opening of a new plant, but noting a shortage in working capital. This letter solicited additional investments in order to get through the slow winter season, but assured investors that the problem would soon be alleviated as revenues began to flow in spring.

13. The tax returns of OCC paint a much different picture regarding its profitability. In 1993 the company had a net taxable loss of $1,547,822. The 1994 return showed a net taxable loss of $1,521,538. After a break-even year in 1995, the 1996 tax return indicated a net taxable loss of $550,340. The 1996 return also showed a net operating loss carryover, dating back to losses generated since 1986, of $1,909,604. Dygert disputed the accuracy of these returns due to certain accounting changes recommended by outside accountants.

14. The record also contains financial statements for the company dated November 20, 1997. These statements compile the financial information for OCC for 1994 through 1997 and do not contain the accounting changes that Dygert objected to. While they reflect the increasing sales that Dygert repeatedly reported to the Noteholders (from $3.8 million in 1994 to $5.9

million in 1997), they also indicate only marginal net income after taxes and interest expense (from $78,000 in 1994 to $80,000 in 1997). The balance sheet manifests rapidly increasing debt (from $4.4 million in 1994 to $6.4 million in 1997). It is further undisputed that, by the time of the bankruptcy filing in 1998, the outstanding Notes alone amounted to $6.1 million.

15. The Plaintiffs were not made aware that OCC was generally only staying afloat because of the continuing investment of capital through the Junior Mortgage Notes. Each year more investments were needed to service the heavy debt load carried by the company. The "profitability" of the company that Dygert announced from time to time in his quarterly reports was calculated before the interest payments on the Notes, which typically exceeded $500,000 annually in later years. Thus, through his creative calculations, Dygert was able to create the illusion of a financially stable business.

16. Dygert also failed to disclose that he had borrowed $100,000 from the company individually and the partnership of Dygert and Dygert had also borrowed $100,000. Both of these loans were written off as uncollectible by OCC in 1997.

17. OCC and Dygert signed an Indenture Trust Agreement on October 14, 1996. This document named Dygert the trustee

for the Junior Mortgage Noteholders. Dygert agrees that one of his fiduciary duties was to obtain security for the Noteholders. Up until that point, the security interest purportedly given by the Junior Mortgage Notes was not properly documented or perfected in any way. Dygert maintains that the failure to secure the Notes in a more timely fashion was excusable because the Notes did not represent a time by which they had to be perfected. Furthermore, he contends that he did not assume any fiduciary duties until the execution of the Indenture Trust Agreement.

18. In 1997, OCC received a $200,000 investment from Donald Drapeau, Jerry Dygert's housemate. Drapeau was granted a security interest in the company's accounts receivable. This interest may have had priority over a portion of the Noteholders' security interest because their interest still had not been perfected with respect to some assets in Iowa.

19. In November of 1998, the Minnesota Commissioner of Commerce issued a ruling with respect to the Junior Mortgage Notes. The ruling found that the Junior Mortgage Notes constituted securities within the provisions of Minn. Stat. § 80A.14 subd. 18 and that they were not registered pursuant to Minn. Stat. § 80A.08. The ruling also found that Dygert was not licensed to sell securities as required by Minn. Stat. § 80A.04. The Commissioner concluded Dygert and OCC violated

Minn. Stat. § 80A.01 by "omitt[ing] disclosure of material facts in the course of offering and selling junior mortgage notes to Minnesota investors, including, but not limited to, the financial status of OCC, the intended use of proceeds from the sale, and the safety of the investment." The Commissioner ordered Dygert and OCC to cease and desist from selling any more Junior Mortgage Notes.

20. Although the Plaintiffs may receive some recovery through OCC's confirmed plan, it is undisputed that all of the Noteholders, including the Plaintiffs, lost a large percentage of their investments as a result of OCC's bankruptcy.

21. All of the Plaintiffs have filed Affidavits, unrefuted by the Defendant, to the effect that they made their initial investment based on the glowing statements by Dygert and prior to the collapse of the business and that they were encouraged through the quarterly reports to maintain those investments despite their right to call them on 30 or 60 days notice. Each has averred that he or she would not have made the initial investment and would not have continued to hold them if they had been told the truth about the financial condition of the company. The record shows that until late 1997 or early 1998, OCC honored all calls on the Notes, which amounted to more than $400,000 in payments in 1997 alone and

millions of dollars over the course of the Junior Mortgage Note program.

22. Following the bankruptcy filing of OCC, the Plaintiffs and other Noteholders began calling on Dygert to honor his guarantees. It became apparent that Dygert had no ability to pay the guarantees as he had very few assets and only earned $3,000 per month. Dygert maintained that he never thought he would have to pay all of the Notes because he always believed that OCC would be able to pay. Dygert's bankruptcy petition soon followed on September 14, 1998.

CONCLUSIONS OF LAW

Summary judgment is governed by Federal Rule of Civil Procedure 56, which is made applicable to this adversary proceeding by Bankruptcy Rule 7056. Federal Rule 56 provides:

> The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law.

Fed. R. Civ. P. 56(c). The moving party on summary judgment bears the initial burden of showing that there is an absence of evidence to support the nonmoving party's case. Celotex Corp. v. Catrett, 477 U.S. 317, 325 (1986). If the moving party is the plaintiff, it carries the additional burden of

presenting evidence that establishes all elements of the claim. Id. at 325; United Mortg. Corp. v. Mathern (In re Mathern), 137 B.R. 311, 314 (Bankr. D. Minn. 1992), aff'd, 141 B.R. 667 (D. Minn. 1992). When the moving party has met its burden of production under Rule 56(c), the burden then shifts to the nonmoving party to produce evidence that would support a finding in its favor. Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 586 (1986). This responsive evidence must be probative, and must "do more than simply show that there is some metaphysical doubt as to the material fact." Id. If the nonmoving party fails to come forward with specific facts showing that there is a genuine issue for trial, summary judgment is appropriate. Id. at 587; Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 249-51 (1986).

I. Section 523(a)(2)(B)

Bankruptcy Code § 523(a)(2)(B) provides that the debtor's discharge does not include a debt:

> for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . use of a statement in writing
> (i) that is materially false;
> (ii) respecting the debtor's or an insider's financial condition;
> (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
> (iv) that the debtor caused to be made or published with intent to deceive.

11 U.S.C. § 523(a)(2)(B) (1994).

At the outset, the Plaintiffs must establish that their debts are for money, property, services, or an extension, renewal, or refinancing of credit. 11 U.S.C. §523(a)(2). There are two separate actions that fit within this definition: (1) each of the investments in the Junior Mortgage Notes and (2) the subsequent decision not to call the Notes on 30 or 60 days notice as provided by the terms of the Notes. There can be no dispute that § 523(a)(2)(B) encompasses the first of these actions. The investments in the Notes constitute debts for an extension of credit as that term is commonly defined. See Field v. Mans, 157 F.3d 35, 42 (1st Cir. 1998) (defining extension to mean "an offer to make available"). This definition of extension of credit not only includes each of the Plaintiffs' initial investments, but also includes the subsequent decision by several of the Plaintiffs to invest additional money in the Junior Mortgage Note program.

The decision not to call the Notes also falls within an alternative definition of extension of credit. In this sense, extension refers to an increase in the length of time to pay the debt. Id.; Foley & Lardner v. Biondo (In re Biondo), 180 F.3d 126, 132 (4th Cir. 1999). The Plaintiffs decided to continue with their investments quarter after quarter and year after year despite the fact that they had the right to call

their Notes on 30 or 60 days notice. In this sense, the Plaintiffs continually gave OCC more time to pay off the debt and, accordingly, their decision not the call the Notes was an extension of credit. See Field, 157 F.3d at 43; Biondo, 180 F.3d at 132.

Having established an extension of credit, the Plaintiffs must establish that such extension was obtained as a result of six elements: (1) the debtor made; (2) a statement in writing; (3) respecting the debtor's or an insider's financial condition; (4) which statement was materially false; (5) which was made with the intent to deceive; and (6) which was reasonably relied upon by the creditor. Security Bank v. Wehri (In re Wehri), 212 B.R. 963, 967-68 (Bankr. D.N.D. 1997).

In this case there is no dispute that the debtor, Dygert, made statements in writing respecting OCC's financial condition when he sent each of the Plaintiffs the quarterly reports. The first question, therefore, is whether OCC was an insider of the debtor. The Code defines an insider of an individual debtor to *include* "a corporation of which the debtor is a director, officer, or person in control." 11 U.S.C. 101(31)(a)(iv) (emphasis added).

Dygert suggests that because in later years he was not in control of the day to day affairs of the business, OCC was not

an insider. However, Dygert was once a director of the corporation. He was also at one point the corporate secretary, which, under Minnesota corporate law, is one of the required corporate officers. Minn. Stat. 300.21. Therefore, during the time periods that Dygert was a director and/or an officer, the corporation was an insider of Dygert regardless of whether he was in control. 11 U.S.C. 101(31)(a)(iv); Kroh Bros. Dev. Co. v. United Mo. Bank (In re Kroh Bros. Dev. Co.), 137 B.R. 332, 335 (Bankr. W.D. Mo. 1992) ("If the Debtor is a director, establishing control is not necessary for the corporation to qualify as an insider.").

Furthermore, the definition of insider is preceded by the term "includes." Thus, the list of examples of insiders is meant to be illustrative, not exhaustive. 11 U.S.C. 102(3); In re Krehl, 86 F.3d 737, 741 (7th Cir. 1996); Solomon v. Barman (In re Barman), 237 B.R. 342, 348 (Bankr. E.D. Mich. 1999). The legislative history suggests that, in addition to the individuals and entities actually named, the term also encompasses anyone with "a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor." Krehl, 86 F.3d at 741 (quoting S. Rep. No. 95-989, reprinted in 1978 U.S.C.C.A.N. 5787, 5810); Barman, 237 B.R. at 348 (quoting Jahn v. Economy Leasing, Inc. (In re Henderson), 96

B.R. 820, 824-25 (Bankr. E.D. Tenn. 1989)). In ascertaining insider status, courts look to the closeness of the relationship between the parties and whether any transactions between them could be considered "arm's length." Krehl, 86 F.3d at 742. Accordingly, to determine whether OCC was an insider of Dygert at times other than when he was a director or officer, I must consider whether there was a sufficiently close relationship that, if Dygert and OCC were engaged in a transaction, it would be subject to close scrutiny.

Under the circumstances of this case, there can be no doubt that Dygert and OCC maintained the type of close relationship necessary to conclude that OCC was an insider of Dygert. Dygert’s wife, son, and son-in-law owned 100% of the stock. Dygert’s son-in-law and grandson managed the business as the corporate officers. Dygert himself held a key position as the principal fund raiser for the corporation. In that role he was intimately familiar with the finances of the business and made recommendations to the management about how much money to raise and from whom. It is apparent from the record that the management consistently followed his advice and, in this regard, treated Dygert as a member of the management team. Indeed, at one point he was held out as being the general supervisor of the finances of the company.

Due to all of these relationships, any transaction that may have taken place between Dygert and OCC would have been subject to close scrutiny. In addition, the loans from OCC to Dygert and his law firm were not arm's length transactions as evidenced by the fact that the company wrote them off as uncollectible without any effort at repayment. Based upon all of these circumstances, I must conclude that OCC was an insider of Dygert. Accordingly, Dygert made a statement in writing respecting an insider's financial condition.

The Plaintiffs must next establish that the statements were materially false. A materially false statement is any statement that paints a substantially untruthful picture of a financial condition by a misrepresentation of the type which would normally affect the decision to grant credit. Jordan v. Southeast Nat'l Bank (In re Jordan), 927 F.2d 221, 224 (5th Cir. 1991), overruled on other grounds, Coston v. Bank of Malvern (In re Coston), 991 F.2d 257 (5th Cir. 1991); Wehri, 212 B.R. at 968; Kunzler v. Bundy (In re Bundy), 95 B.R. 1004, 1008 (Bankr. W.D. Mo. 1989) (holding that a materially false statement is one that is substantially inaccurate). Subjectively, the court must inquire into whether the complaining creditor would have extended credit or renewed an obligation had it been apprised of the true situation. Ramsey Nat'l Bank v. Dammen (In re Dammen), 167 B.R. 545, 551 (Bankr.

D.N.D. 1994). It is well established that writings with pertinent omissions can readily constitute a statement that is materially false for purposes of § 523(a)(2)(B). Jordan, 927 F.2d at 224; Dammen, 167 B.R. at 551; Bundy, 95 B.R. at 1008.

The record reveals that Dygert's statements in the quarterly reports were materially false, in substantial part, as a result of omitted information. While Dygert boasted about the increasing sales and assets, he studiously avoided telling the Plaintiffs about the debt burden of OCC. At the relevant time periods, OCC carried several million dollars in debt that it could not service without incurring more debt each year. Dygert also announced increasing profits, but neglected to take into account the effect of taxes and interest payments on the debt load when calculating "profit." Dygert himself admits that knowledge about liabilities and profitability would be important in evaluating the financial condition of a company. Therefore, the omission of this information was of a type that would affect the decision to grant credit, and the failure to provide such information rendered the quarterly reports materially false.

Dygert points to a number of the quarterly letters which reported arguably negative information about the finances of the company. He argues that the inclusion of this information

negates any finding of material omissions. However, a fair reading of these particular letters results in the conclusion that Dygert may have provided some general information about cash flow or other problems, but, in the same breath, he touted the rising sales figures and offered new investments. Overall, therefore, the reports were materially misleading through their omissions.

At least one of the quarterly reports also contained an affirmative misrepresentation. The letter dated October 1, 1997 stated that net profit after all expenses had doubled over the prior year. Dygert admits that this statement was false. Because such statement painted a substantially untruthful picture of the financial condition of OCC, its falsity was material. Jordan, 927 F.2d at 224; Wehri, 212 B.R. at 968.

The materially false statements must also have been made with the intent to deceive.[3] While a person's intent is generally considered to be a question of fact that is not ordinarily subject to resolution on a motion for summary

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[3] Because of the element of intent, I conclude that the order of the Commissioner of Commerce with respect to Dygert's sale of securities does not have a collateral estoppel effect. Such order contained no finding of intent. See Sprangers v. Interactive Technologies, Inc., 394 N.W.2d 498, 503 (Minn. Ct. App. 1986). Moreover, the Commissioner's order contains no finding that the representations regarding OCC's financial condition were written representations as required by § 523(a)(2).

judgment, intent may be inferred when the evidence is so one sided that reasonable minds could not differ as to the only rational outcome. In re Okan's Foods, Inc., 217 B.R. 739, 755 (E.D. Pa. 1998). Under such circumstances, the court can decide the factual issue of intent as a matter of law. Id.

Proof of fraudulent intent must generally be gleaned from surrounding circumstances because it is rarely susceptible to direct proof. Vangelisti v. Kerbaugh (In re Kerbaugh), 159 B.R. 862, 872 (Bankr. D.N.D. 1993). Under § 523(a)(2)(B), either actual knowledge of the falsity of the information or reckless disregard for the truth of the information satisfies the intent element. Dammen, 167 B.R. at 551; Kerbaugh, 159 B.R. at 872. Thus, the mere fact that the statement was false and the debtor knew it was false has been held determinative of an intent to deceive. Kerbaugh, 159 B.R. at 873. A debtor's mere unsupported assertions of honest intent will not overcome the natural inferences from admitted facts. Id. Moreover, where the debtor is an individual of intelligence and experience in financial matters, courts have been more inclined to hold him responsible for publishing a false financial statement. Jordan, 927 F.2d at 226; Kerbaugh, 159 B.R. at 873.

Dygert's affidavit in response to this motion nowhere explicitly denies an intent to deceive the Plaintiffs. His

only response is that he subjectively continued to believe that OCC was financially healthy and that the Plaintiffs did not require the omitted information. However, Dygert admits that he had intimate knowledge of the financial condition of OCC, including the rising debt load. He also acknowledges that information about liabilities generally would be important in evaluating the financial stability of a business. Furthermore, Dygert was aware of the tax returns that showed substantial losses for the company at the same time he was claiming increasing profits in the quarterly reports. Thus, the overwhelming evidence supports the conclusion that Dygert knew the quarterly reports were materially false. His knowledge of the falsity of the reports is determinative of his intent to deceive. Kerbaugh, 159 B.R. at 873.

Importantly, Dygert is a highly intelligent person who is experienced in financial matters. In light of Dygert's background, it defies common sense to believe Dygert's claim that the Plaintiffs did not need to know the amount of the liabilities and their effect on the net profitability of the business. Even if he subjectively believed that the company was still financially stable, Dygert, at the very least, made the representations with reckless disregard for their truth or falsity. Such recklessness is also sufficient for finding intent. Dammen, 167 B.R. at 551; Kerbaugh, 159 B.R. at 872.

Additionally, Dygert's refusal to provide complete financial statements, even when directly asked, further supports the conclusion that Dygert was intentionally deceiving the Plaintiffs. Accordingly, I find that Dygert's intent to deceive the Plaintiffs can be inferred as a matter of law.

Finally, the Plaintiffs must establish that they relied on Dygert's statements. This element requires both actual and reasonable reliance. Actual reliance mandates that the Plaintiffs did in fact subjectively rely upon or utilize the submitted information when making the decision to extend credit. Dammen, 167 B.R. at 552; Kerbaugh, 159 B.R. at 874. Implicit in this requirement is a showing that the false statement was a contributory cause of the extension of credit. Dammen, 167 B.R. at 552; Kerbaugh, 159 B.R. at 874.

Each of the Plaintiffs' affidavits satisfies the actual reliance requirement. They provide that the Plaintiffs "became . . . Junior Mortgage Note Holder[s] on the basis of Dygert's representations" and that, "if Dygert had truthfully advised [them] of OCC's actual financial condition, [they] immediately would have requested full payment of all principal and interest." Thus, the Plaintiffs have established without contradiction that they actually relied on Dygert's statements in three respects: (1) choosing to make their initial

investment in the Notes; (2) subsequently choosing to purchase additional Notes; and (3) choosing to maintain the investments over the years.

Dygert challenges any actual reliance on the October 1, 1997 letter and its affirmative misrepresentation regarding profitability. He claims in his affidavit that only Plaintiff Irene Wilson received this particular letter. However, Dygert testified at his deposition that all of the Noteholders received identical quarterly letters. Dygert's deposition testimony is controlling over his later, conflicting affidavit. Camfield Tires, Inc. v. Michelin Tire Corp., 719 F.2d 1361, 1365 (8th Cir. 1983) ("A self-serving affidavit that contradicts earlier damaging deposition testimony is not sufficient to create a genuine issue of material fact."). Thus, there is no genuine issue of material fact regarding the Plaintiffs' actual reliance.

The reasonableness of the reliance is an objective determination. Dammen, 167 B.R. at 552; Kerbaugh, 159 B.R. at 874. A court's determination of reasonableness is properly made by considering all of the surrounding circumstances. First Nat'l Bank v. Pontow, 111 F.3d 604, 610 (8th Cir. 1997); Bundy, 95 B.R. at 1009. The stringency of the reasonableness standard varies with the lender's sophistication. Bundy, 95 B.R. at 1009. However, once it has been established that a

debtor has furnished a creditor a materially false financial statement, the reasonableness requirement "cannot be said to be a rigorous requirement, but rather is directed at creditors acting in bad faith." National Union Fire Ins. Co. v. Bonnanzio (In re Bonnanzio), 91 F.3d 296, 305 (2d Cir. 1996); Bank One v. Woolum (In re Woolum), 979 F.2d 71, 76 (6th Cir. 1992). In addition, the existence and nature of any prior relationship or dealings between the parties are also relevant to determine the reasonableness of the creditor's reliance. Bundy, 95 B.R. at 1009.

Dygert's response does not question the reasonableness of the Plaintiffs' reliance. Based on the totality of the circumstances, I must conclude that their reliance was reasonable, especially given that such requirement is not meant to be rigorous. Nothing in the record suggests that the Plaintiffs were highly sophisticated lenders. To the contrary, it appears that they were clients, former clients, or persons who felt especially comfortable relying on Dygert's advice and statements. Nor is there any evidence that Plaintiffs acted in bad faith. Indeed, several of the Plaintiffs asked for additional financial information and were refused by Dygert. Here, too, the failure to protest further suggests a special dependent and trusting relationship. The preexisting relationships between Dygert and the Plaintiffs or

their family members, thus, in part, leads to the conclusion that their reliance on his statements was reasonable.

Dygert finally argues that Plaintiffs cannot establish causation because the company did not have the ability to cash them out at the end. Dygert's argument fails for two reasons. First, all of the Plaintiffs made their initial investments at a time when OCC was able to, and in fact did, cash out other Noteholders. Thus, the material misrepresentations contained in the quarterly reports caused the Plaintiffs to maintain their investments beyond the time when the company had the ability to honor their calls. Second, the Plaintiffs that purchased additional Notes did so in reliance on the earlier quarterly reports. Thus, but for the material misrepresentation contained in those reports, the Plaintiffs would not have made the additional investments. In this respect the company's ability to honor the calls on the Notes is irrelevant.

In sum, Dygert has failed to produce probative evidence to rebut Plaintiffs' prima facie case and raise a genuine issue as to any material fact. The debts that Dygert owes to the Plaintiff are extensions of credit obtained by Dygert's use of a statement in writing that is materially false, respecting an insider's financial condition, on which the

Plaintiffs reasonably relied, and which Dygert published with an intent to deceive.

II. Section 523(a)(2)(A)

Although the prior discussion establishes that Dygert's debt to the Plaintiffs is nondischargeable, I will also consider the Plaintiffs' other claims under § 523(a)(2)(A) and (a)(4).

Section 523(a)(2)(A) provides that a discharge does not include a debt "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition . . . ." 11 U.S.C. § 523(a)(2)(A). Plaintiffs must show (1) the debtor made a representation; (2) at the time the representation was made the debtor knew it was false; (3) the debtor subjectively intended to deceive the creditor at the time he made the representation; (4) the creditor justifiably relied upon the representation; and (5) the creditor sustained injury as a proximate result of the misrepresentation. Merchant's Nat'l Bank v. Moen (In re Moen), 238 B.R. 785, 788 (B.A.P. 8th Cir. 1999); Minnesota Client Security Board v. Wyant (In re Wyant), 236 B.R. 684, 694 (Bankr. D. Minn. 1999).

Pursuant to its terms, § 523(a)(2)(A) excludes from its ambit statements concerning the debtor's or an insider's financial condition. 11 U.S.C. § 523(a)(2)(A); Wyant, 236 B.R. at 697,698. Thus, under this section, Plaintiffs must establish false representations other than those contained in the quarterly reports. There appear to be two such representations: (1) Dygert's personal guarantee; and (2) the statement in each of the Notes promising that they would be secured by a mortgage.

First, I will address Dygert's guarantee. A guarantor's promise to guarantee a debt is a representation that he has the intention to pay the debt. Wyant, 236 B.R. at 698. Accordingly, Dygert's guarantee of each of the Notes amounted to a representation to each of the Plaintiffs that he intended to repay them.

Plaintiffs must further establish that Dygert knew the representation to be false at the time he made it. A promise such as a guarantee is generally only fraudulent if the guarantor had no intent to fulfill his promise at the time it was made. Exeter Bancorporation, Inc. v. Kemper Securities Group, Inc., 58 F.3d 1306, 1312 (8th Cir. 1995); Wyant, 236 B.R. at 698. A representation or expectation as to future acts is not a sufficient basis to support an action for fraud merely because the representation, act, or event did not take

place. Exeter, 58 F.3d at 1312. The failure to carry out such a promise, with nothing more, does not constitute fraud; there must be affirmative evidence that, when the guarantor made the promise, he had no intention of keeping it. Id.

Plaintiffs rely on two pieces of evidence to support their claim that Dygert never intended to fulfill his guarantee. First, he admitted in his deposition that he never expected to have to pay on all of the guarantees. However, Dygert believed, "as all guarantors believe, that payment on the guarantees would not be necessary. Repayment would be accomplished by [OCC] pursuant to the primary terms of the [Notes]." Wyant, 236 B.R. at 698. Therefore, such a statement is insufficient to establish that Dygert lacked the intent to repay the Notes at the time he made the guarantee; he merely expected that he would not have to make such payment himself.

Second, Plaintiffs note that Dygert never had the ability to pay on the guarantees because he only earned $3,000 per month. However, as noted above, § 523(a)(2)(A) specifically prohibits using a non-written representation of a debtor's financial condition as a basis for fraud. Wyant, 236 B.R. at 698. Accordingly, Dygert's inability to pay cannot substitute for a finding that he did not intend to pay. Id. While

Dygert's financial condition may be one indicator of his intentions, it is not determinative. Id.

In a motion for summary judgment, Plaintiffs must present evidence to establish all elements of the claim. Celotex, 477 U.S. at 523; Mathern, 137 B.R. at 314. Because I must make all inferences in favor of the non-moving party, I conclude that the Plaintiffs have not put forth sufficient evidence to establish as a matter of law that Dygert knew the representation to be false when he made it, i.e., that he did not intend to fulfill his guarantees when he signed them. Accordingly, summary judgment is not appropriate under § 523(a)(2)(A) with respect to Dygert's guarantees.

Dygert also represented that the Notes would be secured by a mortgage on "all the real estate, machinery, and equipment of the corporation, and all of its inventory of work in process and finished goods and supplies." Again, the Plaintiffs must establish that Dygert knew this representation was false when he made it. As discussed above, such a promise of future intent is only fraudulent if the promisor had no intention of performing the promise at the time it was made. Exeter, 58 F.3d at 1312; Wyant, 236 B.R. at 698. Here again, the only evidence that Dygert did not intend to perform is the fact that Notes were not secured until sometime after the Indenture Trust Agreement was executed. The delay in carrying

out the promise, with nothing more, does not constitute fraud; there must be affirmative evidence that, when the Dygert made the promise, he had no intention of keeping it. Exeter, 58 F.3d at 1312. Because Plaintiffs point to no other affirmative evidence, I must conclude that summary judgment is also inappropriate under § 523(a)(2)(A) with respect to the promise that the Notes would be secured by a mortgage.

III. Section 523(a)(4)

Bankruptcy Code § 523(a)(4) provides that a debt is not dischargeable if it is "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. § 523(a)(4). As relied upon by the Plaintiffs, § 523(a)(4) requires the Plaintiffs to prove (1) the debtor was acting in a fiduciary capacity and (2) the debtor engaged in fraud or defalcation while acting in that capacity. 11 U.S.C. § 523(a)(4); Dutton v. Kondora (In re Kondora), 194 B.R. 202, 208 (Bankr. N.D. Iowa 1996); Hays v. Cummins (In re Cummins), 166 B.R. 338, 353 (Bankr. W.D. Ark. 1994).

Whether a relationship is a fiduciary one within the meaning of § 523(a)(4) is a question of federal law. Tudor Oaks Ltd. partnership v. Cochrane (In re Cochrane), 124 F.3d 978, 984 (8th Cir. 1997). The fiduciary relationship must be one arising from an express or technical trust that was

imposed before and without reference to the wrongdoing that caused the debt. Id.; Barclays American/Business Credit, Inc. v. Long, 774 F.2d 875, 878 (8th Cir. 1985).

There is a genuine issue of material fact regarding whether Dygert was acting in a fiduciary capacity at the time each of the Plaintiffs made their investments or later decided to continue their investments. First, there is conflicting evidence about whether Dygert owed any of the Plaintiffs fiduciary duties as their attorney. Dygert's affidavit submits that he was not their attorney during the relevant time periods with respect to either their initial investments or their decisions to continue their investments. In this respect, Dygert's affidavit is sufficient to raise a genuine issue of material fact. In addition, the Indenture Trust Agreement was not executed until 1996. Thus, no fiduciary duties arose with respect to that agreement until 1996.

Even after Dygert was named trustee under the Indenture Trust Agreement, there are still genuine issues of material fact with respect to whether Dygert engaged in a defalcation in that capacity.[4] Defalcation is defined as the "misappropriation of trust funds or money held in any fiduciary capacity; [the] failure to properly account for such

[4] As Dygert's fraudulent activities have already been discussed within the context of § 523(a)(2)(A) and (B), I will only focus on the defalcation prong of § 523(a)(4).

funds." Cochrane, 124 F.3d at 984. In general, defalcation refers to a breach of fiduciary duty. Tudor Oaks Ltd. Partnership v. Cochrane (In re Cochrane), 179 B.R. 628, 635 (Bankr. D. Minn. 1995). Defalcation does not require an intentional wrong or bad faith. Cochrane, 124 F.3d at 984; Kondora, 194 B.R. at 208. It can include innocent or negligent misdeeds as well as ignorance. Cochrane, 124 F.3d at 984; Kondora, 194 B.R. at 208; Cummins, 166 B.R. at 354. In short, a defalcation is proven by the simple failure to meet the duties imposed by nonbankruptcy law. Minnesota Trust Co. v. Yanke (In re Yanke), 225 B.R. 428, 437 (Bankr. D. Minn. 1998).

There are material questions of fact as to whether Dygert fulfilled his role as trustee under the Indenture Trust Agreement. For instance, Dygert has raised a genuine issue with respect to whether his role in the Drapeau transaction amounted to a defalcation. It is not clear from the record whether the two security interests were conflicting, and, even if they were, whether the Plaintiffs sustained a loss as a result of Drapeau's senior interest. Moreover, it is disputed whether Dygert acted in a timely manner to secure the Noteholders or perfect their interest once he became trustee. The evidence suggests that he promptly perfected the mortgages soon after the Indenture Trust Agreement was executed.

Finally, even if Dygert had an obligation to obtain security for the Plaintiffs prior to the Indenture Trust Agreement, he has also raised an issue as to whether the Plaintiffs suffered a loss as a result of the delay. He alleges that there was little or no equity in the property.

Accordingly, because there are genuine questions of material fact with respect to whether Dygert was acting in a fiduciary capacity, whether he engaged in a defalcation, and whether there was damage, summary judgment is not appropriate with respect to Plaintiffs' claim under § 523(a)(4).

ORDER FOR JUDGMENT

1. Plaintiffs' motion for summary judgment with respect to their claims under 11 U.S.C. § 523(a)(2)(B) is GRANTED;

2. The debt owed by Debtor-Defendant Robert W. Dygert to David V. Meyer and Geraldine A. Meyer in the amount of $12,368.58 plus interest is excepted from discharge pursuant to 11 U.S.C. § 523(a)(2)(B);

3. The debt owed by Debtor-Defendant Robert W. Dygert to James F. Murphy and Pamela A. Murphy in the amount of $13,312.01 plus interest is excepted from discharge pursuant to 11 U.S.C. § 523(a)(2)(B);

4. The debt owed by Debtor-Defendant Robert W. Dygert to James F. Murphy as custodian for Timothy J. Murphy in the

amount of $2,527.95 plus interest is excepted from discharge pursuant to 11 U.S.C. § 523(a)(2)(B);

5. The debt owed by Debtor-Defendant Robert W. Dygert to Thomas A. Murphy in the amount of $106,180.08 plus interest is excepted from discharge pursuant to 11 U.S.C. § 523(a)(2)(B);

6. The debt owed by Debtor-Defendant Robert W. Dygert to Irene N. Wilson in the amount of $67,845.82 plus interest is excepted from discharge pursuant to 11 U.S.C. § 523(a)(2)(B);

7. The debt owed by Debtor-Defendant Robert W. Dygert to Steven E. Wilson in the amount of $2,367.83 plus interest is excepted from discharge pursuant to 11 U.S.C. § 523(a)(2)(B);

8. The debt owed by Debtor-Defendant Robert W. Dygert to Wendell E. Wilson in the amount of $5,000 plus interest is excepted from discharge pursuant to 11 U.S.C. § 523(a)(2)(B);

9. Plaintiffs' motion for summary judgment with respect to their claims under 11 U.S.C. § 523(a)(2)(A) and (a)(4) is DENIED;

10. Because judgment pursuant to 11 U.S.C. § 523(a)(2)(B) renders all other pending claims moot, there is no just reason for delaying entry of judgment.

LET JUDGMENT BE ENTERED ACCORDINGLY.

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Nancy C. Dreher
United States Bankruptcy Judge