Judge Ninfo-Copy

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UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF NEW YORK

ERIC O. HESS,

Appellant,

v.

ANDREW MASTRODONATO,

Appellee.

DECISION AND ORDER

00-CV-6508L

FILED
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U.S. DISTRICT COURT
WDNY-ROCHESTER

Procedural Background

Appellant, Eric O. Hess ("Hess"), d/b/a Brentwood Mortgage ("Brentwood"), filed a Chapter 7 bankruptcy petition on July 9, 1999. On October 7, 1999, appellee Andrew Mastrodonato ("Mastrodonato") commenced this adversary proceeding against Hess to have a portion of the obligations owed to him by Hess and the now defunct Kingston Homes, Inc., d/b/a Forest Homes of Rochester ("Kingston"), declared nondischargeable pursuant to section 523 of Title 11 of the Bankruptcy Code.

On May 24, 2000, Chief Bankruptcy Judge John C. Ninfo, II conducted a trial during which he heard the testimony of Mastrodonato, Hess, Edward M. O'Brien, Esq. ("O'Brien"), an attorney who represented Mastrodonato, and Paul J. Johnson ("Johnson"), the President of Kingston. In a decision and order, dated August 18, 2000, Chief Judge Ninfo held that Hess had obtained certain mortgage proceeds ("the Mortgage Proceeds") from Mastrodonato by false representations and false

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pretenses within the meaning of 11 U.S.C. § 523(a)(2)(A)[1], and therefore, the amount of the Mortgage Proceeds is nondischargeable. For the reasons stated below, the decision of the bankruptcy court is affirmed.

Factual Background

Chief Judge Ninfo's extensive factual findings are set forth in his decision, and need not be repeated at length here. In short, Hess concedes that he was indebted to Mastrodonato as a guarantor of various obligations due from Kingston to Mastrodonato. Among those obligations was Hess's repayment of a loan Mastrodonato made to Kingston in the amount of $62,000.00 which was evidenced by a promissory note, and secured by a mortgage (the "Old State Road Mortgage") on property owned by Kingston and located in Wyoming County ("Old State Road").

In connection with the closing of the sale of Old State Road, Hess requested that Mastrodonato allow Kingston to retain a portion of the amount that he was entitled to receive at the closing in exchange for a discharge of the Old State Road Mortgage, so that a line of credit which he maintained at Fleet Bank ("Fleet") in the name of Hess d/b/a Brentwood (the "Brentwood Line"), which he also utilized to fund the operations of Kingston, could immediately be paid down to zero for thirty days, with the understanding that once a reborrowing on the Brentwood Line was possible, Hess would cause an immediate reborrowing to the extent necessary to repay Mastrodonato in full plus accrued interest.

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[1] Section 523(a)(2)(A) provides that:

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
>
> > (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, other than a statement respecting the debtor's or an insider's financial condition[.]

11 U.S.C. § 523(a)(2)(A) (2000).

However, following the sale of Old State Road, Hess did not immediately use the Mortgage Proceeds to pay down the Brentwood Line as he had represented to Mastrodonato. Instead, Kingston retained $55,157.14 from the proceeds of the Old State Road closing which should otherwise have been paid to Mastrodonato. In the end, Kingston defaulted in repaying Mastrodonato the Mortgage Proceeds.

Chief Judge Ninfo held that Hess obtained the Mortgage Proceeds from Mastrodonato by false representations and false pretenses within the meaning and intent of section 523(a)(2)(A), and therefore, the amount of the Mortgage Proceeds, together with applicable interest, was nondischargeable. Hess appeals from that decision.

DISCUSSION

I. Standard of Review

Bankruptcy Rule 8013 states that "[o]n an appeal the district court . . . may affirm, modify, or reverse a bankruptcy court's judgment, order, or decree or remand with instructions for further proceedings. Findings of fact ... shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of the witness." Bankr. R. 8013. In reviewing a decision of the bankruptcy court, this court "'must accept the bankruptcy court's findings of fact unless [they are] clearly erroneous,' and will reverse the bankruptcy court 'only if [it is] left with the definite and firm conviction that a mistake has been committed.'" *In re Schubert*, 143 B.R. 337, 341 (S.D.N.Y. 1992) (quoting *In re Manville Forest Prods. Corp.*, 896 F.2d 1384, 1388 (2d Cir. 1990). Conclusions of law are reviewed *de novo*. *In re Manville*, 896 F.2d at 1388 (citing *Brunner v. New York State Higher Educ. Services, Corp.*, 831 F.2d 395, 396 (2d Cir.

1987). Under these standards, there is no basis for reversal or modification of Judge Ninfo's decision.

II. Dischargeability

Bankruptcy law's goal is to "relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." *In re Union Bank of the Middle East, Ltd.*, 127 B.R. 514, 517 (E.D.N.Y. 1991) (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934)) (internal quotation marks omitted). The procedural means to achieve this end is the voluntary petition filed under Chapter 7 of the Bankruptcy Code to "discharge" an individual's debts. *See* 11 U.S.C. § 727; *Union Bank*, 127 B.R. at 517.

There are, however, a number of exceptions to dischargeability. Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, governs the nondischargeability of debts in a Chapter 7 proceeding. A debt that is scheduled pursuant to section 521(1) and Federal Rules of Bankruptcy Procedure 1007(a) and (b)(1) is discharged unless the debt is excepted from discharge under one of the exceptions set forth in section 523(a). *In re Massa*, 187 F.3d 292, 295-296 (2d Cir. 1999).

In this case, Chief Judge Ninfo relied upon section 523(a)(2)(A), which bars discharge from debts for extension of credit "obtained by ... false pretenses, false representation, or actual fraud." The provision gives creditors an opportunity to prove that particular debts arose through impermissible means, and advances the basic principle of bankruptcy law that relief only inures to the debtor with clean hands. *Cf. Local Loan Co. v. Hunt*, 292 U.S. at 244.

For Mastrodonato to succeed on his claim of non-dischargeability, he was required to establish each of the following elements: (1) the debtor made a false representation; (2) that at the

time the representation was made, the debtor knew it was false; (3) that the debtor made the representation with the intention and purpose of deceiving the creditor; (4) that the creditor relied on the representations; and (5) that the creditor sustained loss or damages as the proximate result of the representations having been made. *See, e.g.*, *In re Halperin*, 215 B.R. 321, 334 (Bankr. E.D.N.Y. 1997); *In re Hanna*, 163 B.R. 918, 925 (Bankr. E.D.N.Y. 1994); *In re Schwartz & Meyers*, 130 B.R. 416, 422 (Bankr. S.D.N.Y. 1991); *see also Grogan v. Garner*, 498 U.S. 279, 287 (1991) (reducing the level of proof necessary to block discharge of debts deceptively obtained because "Congress evidently concluded that the creditors' interest in recovering full payment of debts [of this type] outweighed the debtors' interest in a complete fresh start").

Chief Judge Ninfo determined that in order to prevail on a cause of action for false pretenses, Mastrodonato was required to prove that there was a series of events, activities, or communications which created a false and misleading set of circumstances or understanding of a transaction, by which Hess wrongfully induced him to extend credit. *In re Reid*, 237 B.R. 577, 586 (Bankr. W.D.N.Y. 1999); *see also In re Luppino*, 221 B.R. 693 (Bankr. S.D.N.Y. 1998). On the law, Chief Judge Ninfo correctly adhered to the applicable standards in establishing a nondischargeable debt pursuant to section 523(a)(2)(A).

Appellant contends that the bankruptcy court's findings of fact were clearly erroneous.

I note initially the high standard for reversal of a bankruptcy court's fact determinations. In fact, the Bankruptcy Appellate Panel of the Second Circuit has noted that "'[t]o be clearly erroneous, a decision must strike [us] as more than just maybe or probably wrong; it must . . . strike [us] as wrong with the force of a five-week-old, unrefrigerated dead fish.'" *In re Miner*, 229 B.R. 561, 565 (2d Cir. BAP 1999) (quoting *Parts & Elec. Motors, Inc. v. Sterling Elec., Inc.*, 866 F.2d 228, 233

(7th Cir.), *cert. denied*, 493 U.S. 847 (1989)). That colorful, descriptive analogy underscores the deference accorded to the bankruptcy court's factual determinations.

After thoroughly reviewing the record, however, I do not find that the bankruptcy court's findings were clearly erroneous. Quite to the contrary, I find Chief Judge Ninfo's findings to be amply supported in the record.

With respect to the factual findings themselves, the bankruptcy court determined that:

> (1) there was a continuing representation made to Mastrodonato by Johnson and Hess, that Hess participated in by his direct representations or by his knowingly permitting Johnson to make such representations...; (2) the representation was that if Kingston were permitted to retain the Mortgage Proceeds, it or Hess would use them to immediately pay down the Brentwood Line, reborrow on the Line at the earliest possible time, and repay Mastrodonato the Mortgage Proceeds with interest; (3) although Mastrodonato also relied on the proposed Spreader, which was never prepared or executed, and an interest rate of twenty percent per annum until the Mortgage Proceeds were repaid in full, he justifiably relied on the representation that the Mortgage Proceeds would be used only to immediately pay down the Brentwood Line and then there would be a reborrowing on the Line to repay him; (4) Mastrodonato would not have permitted Kingston to retain the Mortgage Proceeds if he knew this continuing representation was not going to be fulfilled; (5) Hess knew that this representation had been made to Mastrodonato, whether by himself, by Johnson or by both of them, directly or through O'Brien, and that Mastrodonato was relying on the representation in permitting the Mortgage Proceeds to be utilized by Hess; (6) Hess did not intend to utilize the Mortgage Proceeds for the purpose represented at the times when he received and cashed the ... [c]heck and utilized the Proceeds in a different manner than represented to Mastrodonato; and (7) Mastrodonato was injured by the failure of Hess to utilize the Mortgage Proceeds to immediately pay down the Brentwood Line, reborrow from the Line at the earliest possible time and repay Mastrodonato the Mortgage Proceeds from the reborrowing.

Bankruptcy Court Decision, Dkt. #1, Ex. C, pp. 5-6.

The testimony presented at trial supports these findings. For example, Mastrodonato, Johnson and O'Brien each testified that it was their understanding that: (1) the Mortgage Proceeds were to be utilized immediately only to pay down the Brentwood Line; (2) after the required "clean up period" when Fleet permitted a reborrowing on the Brentwood Line, a reborrowing was to be made by Hess immediately; and (3) Mastrodonato was to be paid in full from the reborrowing on the Brentwood Line. Trial transcript, Dkt. #1, Ex. F, pp. 26-27, 43-44, 90-92, 132, 147, 150-151,

157. Johnson further testified that he discussed with Hess the need to utilize the Mortgage Proceeds to pay down the Brentwood Line. *Id.*, p. 140. Johnson's testimony alone provided ample evidence for the bankruptcy court to determine that false statements had been made to induce Mastrodonato to part with the approximately $55,000 due him from the Mortgage Proceeds.

The lack of merit of appellant's arguments is thrown into particularly sharp relief when viewed in light of Hess's prior testimony and pleadings. Hess admitted in a 1998 deposition conducted in a state court collection action, commenced prior to the filing of the instant bankruptcy petition, that he knew that false representations were made to Mastrodonato by his partner Johnson, and that Hess acquiesced in them:

> Question: Did you ever discuss with Mr. Mastrodonato that you wished to have the corporation Kingston retain the mortgage amount referenced in Exhibit A so that you would be able to pay off your personal Fleet credit line?
>
> Answer: Paul represented that to Mr. Mastrodonato.
>
> Question: You didn't represent it to Mr. Mastrodonato?
>
> Answer: I went along with Paul because Paul needed the money to do the other things.

Trial transcript, Dkt. #1, Ex. F, pp. 120-121 (quoting Sept. 28, 1998 Hess deposition, p. 47). Similarly, during the trial before the bankruptcy court, Hess did not dispute the fact that a representation was made to Mastrodonato that Hess, or Johnson, or Kingston were going to use Mastrodonato's money to pay down the Brentwood Line. *Id.*, p. 188. Hess further admitted that he used the Mortgage Proceeds to pay the operating expenses of Kingston, and that he never reborrowed on the Brentwood Line to repay Mastrodonato.

Hess's own submissions undermine his position as well. For example, Hess's answer in this action contains what appears to be an admission that false representations had been made to Mastrodonato: "the false representations of the purported use of the funds were not made by himself but by his partner." Answer, Dkt. #1, Ex. E, ¶3. In addition, appellant refers to his "culpable

conduct" in his brief in this appeal. Appellant's brief, Dkt. #4, p. 4. In addition, appellant's counsel, seemed to acknowledge during argument that there had been misrepresentations made when negotiating with Mastrodonato. In view of this record, there is no basis to reverse the bankruptcy court's factual findings.

Hess contends that there must have been reliance by the defrauded party to establish an exception to dischargeability under section 523(a)(2)(A). While that is correct, I reject Hess's assertion that the bankruptcy court erred in finding that Mastrodonato relied on the false representations. The trial testimony establishes that there was no clear error here. In fact, the evidence establishes that Mastrodonato, seeking security in making the loan, relied on the false representations that the Mortgage Proceeds would be used to pay down the Brentwood Line, and, as soon as possible, Hess would reborrow on that line of credit to repay Mastrodonato with interest, and that those terms were "absolutely" a condition of Mastrodonato's loan of the Mortgage Proceeds. Trial transcript, Dkt. #1, Ex. F, testimony of Mastrodonato, p. 30; testimony of Johnson, p. 157.

With respect to appellant's contention that no agreement existed because negotiations were never finalized prior to O'Brien's decision to proceed with the Old State Road closing, it was not clearly erroneous for the bankruptcy court to find that although Mastrodonato also relied on a proposed spreader agreement, he justifiably relied on the representation that the Mortgage Proceeds would be used only to pay down the Brentwood Line, and that there would be a reborrowing on the Line to repay him.

I am also unpersuaded by appellant's contention that the bankruptcy court improperly applied Bankruptcy Code section 523(a)(2)(A) rather than section 523(a)(2)(B)[2]. I initially note that Hess

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[2] Section 523(a)(2)(B) provides, in relevant part:
(a) A discharge under section 727 ... of this title does not discharge an individual debtor from any
(continued...)

failed to raise this issue at the bankruptcy court level. It was not asserted as a defense in Hess's answer, nor does any reference to it appear in the trial transcript. These facts suggest that Hess is impermissibly raising this argument for the first time on appeal, *See In re Ehrle*, 189 B.R. 771, 776 (9th Cir. BAP 1995), and, for that reason alone, I reject the argument.

The rationale underlying Hess's belated argument is that under section 523(a)(2)(A), a *justifiable* reliance standard governs the analysis, while under section 523(a)(2)(B) a *reasonable* reliance standard controls. In other words, section 523(a)(2)(B) bars discharge from debts obtained by written statement respecting the debtor's financial condition if the creditor's reliance on the statements was reasonable. The language of section 523(a)(2)(A), on the other hand, which addresses oral and other written representations by the debtor, establishes no such requirement. "The distinction makes sense--*i.e.*, lending institutions should be held to a higher standard of reliance for representations made in instruments typically at the foundation of a credit application than for oral and supplemental written representations, which are generally less vital to the process and more difficult to substantiate." *In re Luthra*, 182 B.R. 88, 92 (E.D.N.Y. 1995). Whatever its rationale, the fact remains: Congress wrote a reasonable reliance requirement into section 523(a)(2)(B), and not into section 523(a)(2)(A). *Id.* Therefore, in assessing the claim at hand, Chief Judge Ninfo correctly

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[2] (...continued)
debt--

(2) for money, property, services, or an extension, renewal or refinancing of credit, to the extent obtained by--

(B) 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).

determined that Mastrodonato's reliance only needs to be justifiable. *Field v. Mans*, 516 U.S. 59 (1995). The bankruptcy court committed no error of law in so doing.

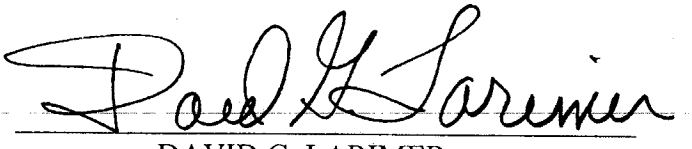
Appellant's remaining contentions require little comment. Hess suggests that he was entitled to invoke the protections of New York's CPLR 1401 regarding contribution as well as New York General Obligations Law ("GOL") 15–108 based upon O'Brien's alleged negligence, and that the bankruptcy court failed to apportion Mastrodonato's damages between Hess and O'Brien. However, appellant cites nothing to support this novel argument. Indeed, appellant's counsel admitted at argument that he has no authority whatsoever to support his position. *See also* Appellant's Reply Brief, Dkt. #8, p. 24 (wherein Hess asserts that "[m]erely because reliance on GOL 15–108 has never been reported does not mean there is no merit to the claim"). I reject appellant's argument as lacking any support in the United States Bankruptcy Code or relevant case law.

Hess also argues that he was injured by Chief Judge Ninfo's decision not to admit a cooperation agreement between O'Brien and Mastrodonato. Appellant claims that the agreement is unenforceable on the amorphous ground that it is against public policy. I disagree, but even if I did not, appellant has not demonstrated that the bankruptcy court's evidentiary ruling was manifestly erroneous. *Malarkey v. Texaco, Inc.*, 983 F.2d 1204, 1210 (2d Cir. 1993) (evidentiary rulings made by a trial judge are ordinarily overturned only when found to be manifestly erroneous).

CONCLUSION

The Decision and Order of the bankruptcy court, entered on August 18, 2000, is hereby affirmed.

IT IS SO ORDERED.



DAVID G. LARIMER
CHIEF JUDGE
UNITED STATES DISTRICT COURT

Dated: Rochester, New York
November 19, 2001.

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF NEW YORK

Hess

Plaintiff(s)

v. 6:00-cv-06508

Mastrodonate

Defendant(s)

PLEASE take notice of the entry of an ORDER filed on 11/19/01, of which the within is a copy, and entered 11/19/01 upon the official docket in this case. (Document No. 11 .)

Dated: Rochester, New York
November 19, 2001

RODNEY C. EARLY, Clerk
U.S. District Court
Western District of New York
2120 U.S. Courthouse
100 State Street
Rochester, New York 14614

Enclosure
TO:

David MacKnight, Esq.
Mary Jo S. Korona, Esq.