UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In Re:

RICHARD J. COLOMBO, **BK. NO. 93-21983**

Debtor.

MICHAEL PERRY,

Plaintiff

vs. **A.P. No. 93-2225**

RICHARD J. COLOMBO,

Defendant.

BACKGROUND

On September 1, 1993, the Debtor, Richard J. Colombo, (the "Debtor") filed a petition initiating a Chapter 7 case. On his schedules, the Debtor listed: (1) his ownership of a residence at 7769 Dryer Road and indicated that it had a value of $100,000 and was subject to mortgage liens of in excess of $120,000; (2) six creditors with unsecured claims totalling $60,352.52, including an obligation to Michael Perry ("Perry") in the amount of $50,000; and (3) his ownership of a one-third interest in Colonial Cruise as having no value.

On December 3, 1993, Perry commenced an adversary proceeding (the "Adversary Proceeding") against the Debtor to have a July 30, 1993 New York State Supreme Court, Monroe County Final Judgment in the amount of $40,985.94 (the "Default Judgment") determined to be nondischargeable pursuant to the provisions of Sections 523(a)(4) and 727 of the Bankruptcy Code.

In his Complaint and other pleadings, Perry alleged that: (1) for a number of years prior to February 8, 1990, Perry and the Debtor had an informal partnership to build, market and sell replica boats; (2) on February 8, 1990, Perry, the Debtor and Daniel P. Colombo ("Dan Colombo"), the

Debtor's brother, entered into a written partnership agreement (the "Partnership Agreement")[1] which formed a new partnership (the "Partnership") to formalize the informal partnership between Perry and the Debtor and to add Dan Colombo as a partner; (3) on or about March 2, 1990, Rochester Launch Company, Inc. was incorporated; (4) without Perry's consent the assets of the Partnership were taken over, utilized and sold or disposed of by Rochester Launch Company, Inc., the Debtor and Dan Colombo; (5) neither the proceeds of the sales nor an amount equivalent to the fair market value of the other Partnership assets utilized or disposed of were paid to either the Partnership or Perry as a member of the Partnership; (6) in early 1991, Perry commenced an action in New York State Supreme Court against the Debtor and Dan Colombo (the "State Court Action") wherein he sought, among other damages, to recover from the Debtor and Dan Colombo damages for their breach of an alleged agreement to compensate him for his capital contributions to and efforts on behalf of the Partnership; (7) the Debtor and Dan Colombo initially defended the State Court Action, interposing an Answer, participating in discovery, having an attorney appear for them at a ready trial calendar call and participate in settlement negotiations, however, they failed to appear at a trial in the Action; (8) as a result of the defendants' failure to appear for trial in the State Court Action, on July 22, 1993 a default judgment on the issue of liability was entered[2] and a hearing on damages was conducted on July 23 and July 26, 1993; (9) the Debtor and Dan Colombo failed to appear for the hearing on damages; and (10) after taking proof at the hearing on damages, the State Court issued

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[1] The Partnership Agreement simply read: "We the undersigned agree that the Rochester Launch Co. (Rochesterville Launch Co.), a manufacturer of boats, is a business owned by: Michael Perry, Richard Colombo and Daniel P. Colombo. Ownership is divided into equal thirds."

[2] At the hearing on July 22, 1993, Supreme Court Justice Harold L. Galloway set forth in detail the notifications given directly by the Court to the Debtor and Dan Colombo who were at various times proceeding *pro se* in the Action (Exhibit G to Perry's Motion for Summary Judgment).

a Decision (the "Decision")[3] and thereafter entered the July 30, 1993 Default Judgment.

After the Debtor interposed an Answer in the Adversary Proceeding, a pretrial conference was conducted on February 22, 1994, wherein it was determined that: (1) the Section 727 allegations in Perry's Complaint were inadvertent and would be withdrawn; (2) the Proceeding would continue for a determination of dischargeability under Section 523(a); and (3) the Proceeding was placed on the Trial Calendar for April 20, 1994 in order to give the parties sufficient time to conduct discovery and for Perry to make a motion for summary judgment to have the Court determine whether the Default Judgment was *res judicata* regarding the issue of dischargeability or whether all or any of the findings of fact and conclusions of law contained in the Decision should be afforded collateral estoppel effect. At the pretrial conference, the parties were advised that, based on the pleadings, including the Decision, the Court's principal focus in connection with its determination of dischargeability would be on the provisions of Section 523(a)(6).[4] This was primarily because the

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[3] The Decision issued by Justice Galloway determined that Perry had contributed $8,397.65 in materials, labor and expenses as a capital contribution in connection with a prototype boat ("Boat #1"), and $22,286.56 in materials, labor and expenses as a capital contribution in connection with a second boat (the "Malloy Boat"), which boats were Partnership assets. The Decision found, based on the evidence presented at the hearing on damages that these Partnership assets were converted by the defendants. The Decision further granted Perry a judgment for these amounts and indicated that they represented a repayment of capital contributions based on Perry's testimony and allegations that the partners had agreed that these capital contributions would be repaid before the division of any profits and that the value of the boats and other Partnership assets exceeded the total of these capital contributions.

[4] Section 523(a)(6) provides:

> (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–
>
> > (6) for willful and malicious injury by the debtor to another entity or to the property of another entity.

Decision had found that the actions of the Debtor and Dan Colombo constituted a conversion of the Partnership assets, and, therefore, such actions might be found by this Court to be a willful and malicious injury.

On April 8, 1994, Perry filed a Motion for Summary Judgment (the "Motion for Summary Judgment") which requested a determination by the Court that the Default Judgment was entitled to *res judicata* effect as a final judgment for all purposes, including nondischargeability under Section 523(a). Attached as an exhibit to the Debtor's opposition to the Motion for Summary Judgment was an Affidavit by an attorney which indicated that the Debtor and Dan Colombo had failed to appear at the trial and the hearing on damages in the State Court Action because of a miscommunication with that attorney who, although he claimed not to formally represent them: (1) appeared for them at the Ready Trial Calendar Call; (2) participated in settlement discussion at that Calendar Call; (3) was advised by the Court of the trial date; and (4) claims not to have advised the Debtor and Dan Colombo of the trial date because he believed that the matter was settled.

On April 18, 1994, the Court entered an Order Amending Perry's Complaint, which provided for the withdrawal of the Section 727 cause of action and for Perry to proceed in the Adversary Proceeding pursuant to Section 523(a)(4).[5] The Court signed the Order, which was presented as being by consent, even though it did not specifically shift the focus to include Section 523(a)(6) in accordance with the pretrial discussions.

At a June 1, 1994 hearing, the Court stayed all proceedings in the Adversary Proceeding,

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[5] Section 523(a)(4) of the Bankruptcy Code provides:

> (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–
> (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.

including the Motion for Summary Judgment, to afford the Debtor an opportunity to move in the State Court for an order vacating the Default Judgment on the basis of excusable neglect.[6]

On June 7, 1994, an Order was entered which stayed the Motion for Summary Judgment and all proceedings in the Adversary Proceeding until the New York State Supreme Court had either denied the Debtor's motion to vacate the Default Judgment or, if the Debtor's motion was granted, a State Court trial on the issues was concluded. The parties were advised that if the Default Judgment was vacated and a trial was conducted in State Court, it should be prepared for and litigated with a view towards the Court's ultimate determination of the dischargeability issues in the pending Adversary Proceeding.[7]

On July 1, 1994, Justice Galloway issued an Order Denying the Motion of the Debtor and Dan Colombo to vacate the Default Judgment, a copy of which was filed with the Court on July 12, 1994.

Thereafter: (1) an additional pretrial hearing was conducted on July 26, 1994, at which time the Court again focused the parties on the elements required for a determination of nondischargeability under Section 523(a)(6); (2) the Adversary Proceeding was placed on the Trial Calendar for August 17, 1994; (3) the Motion for Summary Judgment was restored to the calendar

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[6] The one year statute of limitations provided for under New York State law to bring such a motion had not yet expired.

[7] In *In re Bohrer*, No. 92-21223, A.P. 92-2094 (Bankr. W.D.N.Y., Feb. 8, 1994) this Court entered an Order Lifting the Stay to allow an action, which also had non-debtor defendants, to proceed in State Court with the specific directions and expectations that the parties would present and litigate the matters so that the State Court would make such specific findings of fact and conclusions of law that the Bankruptcy Court could then determine the issues of nondischargeability by reviewing those findings of fact and conclusions of law. In that case, however, the debtor failed to appear at the State Court trial, and for the reasons set forth in the decision, the Court found the indebtedness in question to be nondischargeable.

for August 17, 1994 so that the Court could render its decision on the Motion; and (4) the Court required the Debtor to file a written accounting for the Partnership through March 3, 1990 by no later that August 15, 1994.[8]

On August 15, 1994, the Debtor filed a document titled "Pre-Incorporation Accounting for Rochesterville Launch Company" (the "Partnership Accounting").

On the August 17, 1994 return date the Court denied Perry's Motion for Summary Judgment and set the matter down for trial. A trial was conducted on September 22 and 23, 1994, at which the Court heard the testimony of Perry, the Debtor, Dan Colombo and James Vazzana, Esq. ("Attorney Vazzana"), an attorney who had worked with the parties in connection with the incorporation of Rochester Launch Company, Inc.

DISCUSSION

I. The Doctrines of *Res Judicata* and Collateral Estoppel.[9]

Although the issue of nondischargeability of a debt is exclusively a matter of federal bankruptcy law, the law is nevertheless clear that the Bankruptcy Court must give collateral estoppel effect to those elements of a non-bankruptcy claim that are identical to the elements required for discharge and which were actually litigated and determined by a prior action. *Grogan v. Garner*, 498 U.S. 279, 284-85 n.11 (1991). Collateral estoppel precludes the relitigation of an issue of fact or law

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[8] Perry had requested but never received this accounting and the Court believed that his receipt of the accounting might facilitate the settlement negotiations which the parties were conducting.

[9] For a discussion of the preclusive effect of State Court judgments in bankruptcy courts *See* Jeffrey Thomas Ferriell, *The Preclusive Effect of State Court Decisions in Bankruptcy* (pts. 1 & 2), 58 AM. BANKR. L.J. 349 (1984), 59 AM. BANKR. L.J. 55 (1985). For a thorough discussion of the doctrines in bankruptcy courts where New York State law is involved, *See In re Cohen*, 92 B.R. 54 (Bankr. S.D.N.Y. 1988).

before a bankruptcy court that was previously determined by another court. *Kelleran v. Andrijevic,* 825 F.2d 692 (2d Cir. 1987), *cert. denied,* 484 U.S. 1007 (1988).

The policies underlying the doctrines of *res judicata* and collateral estoppel (claim and issue preclusion) include protecting litigants from the unnecessary burden of relitigating identical issues, promoting judicial economy, preventing inconsistent decisions, encouraging reliance on judicial proceedings and decisions, encouraging parties not to ignore proceedings but to participate in them to conclusion and promoting comity between courts.

In an Adversary Proceeding respecting dischargeability, there are three elements to be determined. These elements are liability, damages and dischargeability. Although a non-bankruptcy court may have considered the issues of liability and damages, it may not rule on the ultimate question of dischargeability. The Bankruptcy Court, however, may adopt the findings of the non-bankruptcy court where they have been fully litigated, and such findings may apply to the issues of liability, damages and in some cases issues such as fraud, larceny, embezzlement and willfulness. *In re Magnafici*, 16 B.R. 246, 252-53 (Bankr. N.D.Ill. 1981).

In this case, for the Court to make a determination of nondischargeability it must make a determination that the actions of the Debtor and Dan Colombo with respect to Perry, the Partnership and the Partnership assets resulted in a willful and malicious injury within the meaning and intent of Section 523(a)(6) of the Bankruptcy Code. Perry's Motion for Summary Judgment on the grounds that the doctrines of *res judicata* or collateral estoppel applied to the issue of dischargeability was denied and a trial was required because: (1) the Complaint in the State Court Action was grounded primarily in contract and did not even allege willful and malicious behavior; (2) from the other pleadings in the State Court Action, this Court could not determine the issue of willful and malicious injury; and (3) the Decision, even though it found that there was a conversion, contained no findings of fact or conclusions of law from which this Court could determine that the actions of the

defendants were willful and malicious within the meaning and intent of Section 523(a)(6).

As to whether the doctrine of collateral estoppel should be found to apply as to Justice Galloway's determinations of liability and damages as set forth in his Decision and incorporated into the Default Judgment, which was not appealed, the law is clear that in considering the preclusive effect of a prior State Court judgment, the Bankruptcy Court must apply the collateral estoppel law of the state. *Marrese v. American Academy of Orthopedic Surgeons*, 470 U.S. 373, 381-82, (1985), *reh'g denied* 471 U.S. 1062 (1985); *Kelleran v. Andrijevic*, 825 F.2d 692 (2d Cir. 1987), *cert. denied,* 484 U.S. 1007 (1988).

Further, the Second Circuit has held that what is required is not necessarily the full and complete litigation of an issue but that there was a full and fair opportunity to litigate the issue in a prior action or proceeding. That Court has held that the "proverbial 'right to a day in court' does not mean the actual presentation of the case in the context of a formal, evidentiary hearing, but rather 'the right to be duly cited to appear and to be afforded an opportunity to be heard.'" *Mitchell v. National Broadcasting Co.*, 553 F.2d 265, 271 (2d Cir. 1977) (citing *Olsen v. Muskegon Piston Ring Co.*, 117 F.2d 163, 165 (6th Cir. 1941).

After reviewing the pleadings and proceedings in the State Court Action, this Court finds that the Debtor had a full and fair opportunity in the Action to be heard on the issues of liability and damages and, therefore, the Default Judgment must be afforded preclusive effect on those issues. To the extent there was a breakdown in communication between the Debtor and the Court or the attorney who appeared for the Debtor and was advised of the Trial date, the Debtor must bear the responsibility and the consequences. Justice Galloway, in denying the Debtor's Motion to Vacate the Default Judgment, clearly determined that any such miscommunication did not even constitute excusable neglect. Furthermore, Perry's Complaint in the State Court Action and the other pleadings available to this Court, including the Defendant's Answers to Interrogatories, indicate that the Debtor

and Dan Colombo were on sufficient notice of Perry's theories of liability and damages, including his assertion that he was entitled to both his out-of-pocket expenses and labor in connection with the Partnership.[10]

II. Willful and Malicious Injury - §523(a)(6)

This Court has previously held that it agrees with those courts which have held that the proper standard to be employed in making determinations under Section 523(a)(6), when the Court must balance "fresh start" policy and nondischargeability considerations, is that the creditor must prove, by a preponderance of the evidence, that the injury in question resulted from an act that was both willful, deliberate or intentional, and malicious, wrongful and without just cause or excuse, even in the absence of personal hatred, spite or ill will. *See In re Muhammad*, 135 B.R. 294, 298 (Bankr. N.D.Ill. 1991). A Debtor's conduct is malicious if he knew or should have known that the conduct would cause harm to the creditor. *In re Cohen*, 121 B.R. 267, 271 (Bankr. E.D.N.Y. 1990).[11]

Based on the pleadings and proceedings in this case, including the testimony of the witnesses at trial, the Court agrees with the Decision of Justice Galloway in the State Court Action that the

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[10] Although based on the Partnership Accounting and the testimony of the witnesses at the trial this Court may have determined a different measure of damages for Perry's lost interest in the Partnership, that is irrelevant once a determination has been made that collateral estoppel applies. As this Court has indicated on a number of occasions, it is not an appeals court for the courts of the State of New York. Furthermore, this Court's possible determination of the measure of damages (Perry's interest in the Partnership): deducting the amount claimed for Perry's labor, accepting Perry's valuation of the Partnership assets, deducting the out-of-pocket expenses of the partners in connection with the Partnership (with the out-of-pocket expenses of the Debtor and Dan Colombo adjusted downward as being mere estimates in view of the fact that no receipts were available) and dividing the remaining value by three, might not be significantly different than the damages determined by Justice Galloway in the Decision.

[11] *See In re Chapin*, 155 B.R. 323 (Bankr. W.D.N.Y. 1993).

Debtor and Dan Colombo converted the assets of the Partnership for their own use and benefit and for the use and benefit of Rochester Launch Company, Inc. without the consent of Perry. The Court further finds, based on the testimony at trial and its evaluation of the credibility of the witnesses, that such conduct on the part of the Debtor was: (1) willful; (2) deliberate and intentional; (3) malicious; and (4) done knowing that it would result in harm to Perry by depriving him of his agreed interest in the Partnership. From the testimony at trial it is clear that before any of the Partnership assets or their proceeds, including the Malloy Boat proceeds, were utilized or distributed by the Debtor, Dan Colombo or Rochester Launch Company, Inc., Perry had clearly evidenced his lack of consent to such utilization or distribution, and had demanded an accounting for the Partnership. As a result, the actions of the Debtor in thereafter utilizing the Partnership assets and distributing the proceeds of the sale or other disposition of the assets, or knowingly allowing such utilization or distribution, were contrary to New York State Partnership Law, and the agreement of the parties, without just cause or excuse and willful and malicious within the meaning and intent of Section 523(a)(6).

III. Section 523(a)(4)

Courts and commentators disagree as to whether partners are fiduciaries within the meaning and intent of Section 523(a)(4). At least some New York courts have found that under New York State law partners are such fiduciaries, at least with respect to the proceeds of partnership assets. *See In re Stone,* 90 B.R. 71 (Bankr. S.D.N.Y. 1988), *aff'd,* 94 B.R. 298 (S.D.N.Y. 1988), *aff'd mem.*, 880 F.2d 1318 (2d Cir. 1989). Because it has been determined that the Default Judgment is nondischargeable because the Debtor's conduct resulted in willful and malicious injury within the meaning and intent of Section 523(a)(6), it is not necessary for the Court to determine whether all or any part of the indebtedness evidenced by the Default Judgment would be nondischargeable pursuant to the provisions of Section 523(a)(4).

CONCLUSION

The New York State Supreme Court Judgment in favor of Michael Perry against the Debtor in the amount of $40,985.94, together with interest as provided for under New York State law, is determined to be nondischargeable pursuant to the provisions of Section 523(a)(6) of the Bankruptcy Code.

IT IS SO ORDERED.

_____/s/_____
HON. JOHN C. NINFO, II
U.S. BANKRUPTCY COURT JUDGE

Dated: December 20, 1994