

**UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK**

In re:

ERIC O. HESS,

Debtor.

CASE NO. 99-22144

DECISION & ORDER

ANDREW MASTRODONATO,

Plaintiff,

V.

AP #99-2289

ERIC O. HESS,

Defendant.

BACKGROUND

On July 9, 1999, Eric O. Hess (“Hess”), d/b/a Brentwood Mortgage (“Brentwood”), filed a petition initiating a Chapter 7 case. On the Schedules and Statements required to be filed pursuant to Section 521 and Rule 1007, Hess: (1) indicated that he was the sole shareholder of Kingston Homes, Inc., d/b/a Forest Homes of Rochester (“Kingston”), which was now defunct; (2) indicated that he was indebted to Andrew Mastrodonato (“Mastrodonato”) as a guarantor of various obligations due from Kingston to Mastrodonato, which were in the approximate amount of \$386,000.00; and (3) scheduled unsecured indebtedness in excess of \$532,000.00.

On October 7, 1999, Mastrodonato commenced an Adversary Proceeding against Hess to have a portion of the obligations owed to him by Kingston and Hess determined to be nondischargeable pursuant to Section 523. The Complaint in the Adversary Proceeding alleged that:

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(1) on or about November 9, 1992, Mastrodonato lent Kingston \$62,000.00 which was: (a) evidenced by a promissory note (the “Mastrodonato Note”); and (b) secured by a mortgage (the “Old State Road Mortgage”) on property owned by Kingston and located in Wyoming County, New York (“Old State Road”); (2) in connection with the closing of the sale of Old State Road in 1994, 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, as required by Fleet on an annual basis, with the understanding that once a reborrowing on the Line was possible, Hess would cause an immediate reborrowing to the extent necessary to repay Mastrodonato in full plus accrued interest at twenty percent (20%) for the period between the closing and the repayment; (3) after the closing costs and a payment to Mastrodonato, \$55,157.14 was retained by Kingston from the proceeds of the Old State Road closing which should otherwise have been paid to Mastrodonato (the “Mortgage Proceeds”); (4) on or about July 6, 1994 the Mortgage Proceeds were paid to Eric Hess/Brentwood by a check drawn on an account maintained in the name of Forest Homes of Rochester (the “Forest Homes Check”); (5) Hess did not immediately use the Mortgage Proceeds to pay down the Brentwood Line as represented to Mastrodonato; (6) Kingston defaulted in repaying Mastrodonato the Mortgage Proceeds; and (7) the indebtedness resulting from the retention of the Mortgage Proceeds and the failure to utilize them as represented, to immediately pay down the Brentwood Line and then, as soon as possible, reborrow the amount of the Mortgage Proceeds and pay it to Mastrodonato, should be determined by the Court

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to be nondischargeable pursuant to Section 523(a)(2)(A),¹ because the Mortgage Proceeds were obtained by false representations, false pretenses or actual fraud.

On May 24, 2000, the Court conducted a trial at which it heard the testimony of Mastrodonato, Hess, Edward M. O'Brien, Esq., an attorney who represented Mastrodonato, ("O'Brien") and Paul J. Johnson, the President of Kingston ("Johnson").

At the trial, Hess testified that: (1) there was no written agreement entered into among Mastrodonato, Kingston and Hess which set forth the specific terms and conditions upon which Kingston and Hess could use the Mortgage Proceeds; (2) as the result of various oral conversations among Mastrodonato, Johnson, O'Brien and Hess, Hess understood that the Mortgage Proceeds could be utilized by him and Kingston, provided that: (a) Mastrodonato received interest on the Mortgage Proceeds at the rate of twenty percent (20%) per annum until they were repaid, which was the post-maturity interest rate on the Brentwood Line; (b) Mastrodonato received a Spreader Agreement (a "Spreader") from Kingston which would secure the Mortgage Proceeds indebtedness by mortgages on various other properties owned by Kingston on which Mastrodonato already held first mortgages; (c) Mastrodonato was to be paid from the proceeds of the sale of Old State Road,

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 re financing 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).

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the amount which would bring all of his first mortgages current through the date of closing, including the Old State Road Mortgage; (d) the Mortgage Proceeds were to be used for no purposes other than to: (i) pay the ongoing operating expenses of Kingston, so that it could finish the homes on which Mastrodonato held first mortgages; and (ii) ultimately pay down the Brentwood Line; (3) Hess used the Mortgage Proceeds to pay the operating expenses of Kingston; and (4) at some point in the Fall of 1994, the Brentwood Line was paid down as required by Fleet but Hess never reborrowed on the Line to repay Mastrodonato.

At the trial 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 immediately be made by Hess; and (3) Mastrodonato was to be paid in full from the reborrowing on the Brentwood Line.

At the trial Johnson further testified that at the time he and Hess cosigned the Forest Homes Check, which was made payable to Hess and Brentwood, he discussed with Hess the need to utilize those funds to pay down the Brentwood Line.

DISCUSSION

To prevail on a cause of action for false pretenses, Mastrodonato must prove that: (1) a false representation was made with the intent to deceive him; (2) he relied on the representation; and (3) he sustained the injury due to his reliance. See *In re Young*, 91 F.3d 1367 (10th Cir. 1996); *In re*

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Shaheen, 111 B.R. 48 (Bankr. S.D.N.Y. 1990). In addition, Mastrodonato's reliance only needs to be justifiable. *Field v. Mans*, 516 U.S. 59 (1995).

To prevail on a cause of action for false pretenses, Mastrodonato must 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 (Bankr. W.D.N.Y. 1999); *In re Luppino*, 221 B.R. 693 (Bankr. S.D.N.Y. 1998).

After having heard the testimony of the witnesses at trial, observed the witnesses and their demeanor, formed an opinion as to the credibility of the witnesses, and reviewed the documentary evidence admitted at trial, including the State Court depositions, I find 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, which continued up to the time when Hess cashed the Forest Homes Check; (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 (20%) 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

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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 Forest Homes Check 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.

CONCLUSION

I find 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 Mortgages Proceeds, together with interest at the federal judgment rate from the date of the Old State Road closing until the payment that Mastrodonato received from O'Brien's law firm, together with interest at the federal judgment rate after the application of that payment, first to accrued interest and then to principal, is nondischargeable.

Because the parties did not enter into formal written agreements regarding the use of the Mortgage Proceeds, neither the terms of the Mastrodonato Note and the Old State Road Mortgage nor the parties' oral arguments regarding an interest rate govern the measure of the nondischargeable damages suffered by Mastrodonato as the result of Hess obtaining the use of the Mortgage Proceeds

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by false representations and false pretenses, specifically, the interest rate and the recovery of any costs and expenses, including reasonable attorneys fees.

IT IS SO ORDERED.

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

Dated: August 18, 2000