UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In Re:

David William Russell, **BK. NO. 93-22321**

Debtor.

Joel Conklin,

Plaintiff,

vs. **A.P. NO. 94-2015**

David William Russell,

Defendant.

BACKGROUND

On October 21, 1993, the Debtor, David William Russell (the "Debtor"), who had been in the wholesale and retail florist business, filed a petition initiating a Chapter 11 case. On his schedules, the Debtor listed: (1) as his only assets, miscellaneous personal property valued at $5,350.00; (2) priority state and federal tax claims totalling $77,333.58; and (3) unsecured claims totalling $195,562.67, including an obligation to Joel R. Conklin ("Conklin") in the amount of $39,264.02.

On January 27, 1994, the Office of the United States Trustee filed a Motion to Convert or Dismiss the Debtor's Chapter 11 case, and on February 24, 1994 the Court, pursuant to Section 1112(b), converted the case to a Chapter 7 case.

Also on January 27, 1994, Conklin commenced an adversary proceeding (the "Adversary Proceeding") to have two prepetition New York State Supreme Court, Saratoga County, Final Judgments determined to be nondischargeable under Sections 523(a)(2)(A), (a)(4), (a)(6) and (a)(7). These Judgments were entered as the result of a New York State Supreme Court, Saratoga County, action commenced by Conklin against the Debtor (the "State Court Action"). The first judgment (the

"Sanction Judgment") was based on the December 24, 1992 Order (Pl. Ex. 10 at Trial) of Justice Jan H. Plumadore ("Justice Plumadore") which awarded Conklin attorney's fees and costs based on "defendant's frivolous litigation conduct" in connection with a discovery motion brought on behalf of Conklin.[1] The second judgment (the "Dispositive Judgment") (Pl. Ex. 11 at Trial) in the total amount of $39,264.02 was entered pursuant to a June 2, 1993 Order of Justice Plumadore.[2]

The Complaint in the Adversary Proceeding alleged that the State Court Action was based on a number of separate causes of action to recover damages resulting from: (1) the Debtor's alleged fraud in connection with Conklin's purchase of 10,000 shares of common stock in the Village Green Bookstores, Inc. (the "Village Green"); (2) the Debtor's failure to perform his obligations under a sub-lease of a 1988 Porsche (the "Porsche") leased by Conklin from Porsche Financial Services ("Porsche Financial"); and (3) the Debtor's failure to pay a number of parking tickets which he received while using the Porsche, which remained registered to Conklin, and which Conklin was required to pay in order to be able to renew his New York State driver's license.

After a number of pretrial conferences and related proceedings, a trial in the Adversary Proceeding was conducted on November 30, 1994 at which the Court heard the testimony of Conklin, the Debtor, Susan Russell, the Debtor's spouse, and a number of other witnesses.

The testimony of the witnesses and the documentary evidence received at trial indicated that:

(1) the Debtor, who lived in Rochester, New York and Conklin, who lived in Liverpool, New York, approximately 80 miles away from Rochester, first met when the Debtor answered Conklin's advertisement in a swap sheet seeking an individual to take an assignment of his lease of the Porsche;

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[1] At trial, the Court received into evidence as Plaintiff's Exhibit 10 a copy of the December 24, 1992 Order. The Court was not supplied with a copy of the Sanction Judgment, however, the Complaint in the Adversary Proceeding alleges that a judgment was entered.

[2] The Dispositive Judgment was for damages (principal, interest and punitive damages) on ten separate causes of action together with costs and disbursements of $631.10.

(2) thereafter, the Debtor and Conklin had several face-to-face meetings during which there were discussions about the Debtor's desire to lease the Porsche and his ongoing attempts to obtain a controlling interest in the Village Green, a bookstore and novelty items chain in the Rochester area;

(3) during these ongoing discussions, the Debtor discussed his business background and his current involvement in the retail and wholesale florist business;

(4) although it was Conklin's initial desire that the Debtor take an assignment of his lease of the Porsche, which would necessitate the payment of a $350.00 transfer fee and require the Debtor to, among other things, complete a financial statement for review by Porsche Financial, ultimately the parties entered into an April 9, 1991 Motor Vehicle Sublet Agreement (the "Sublet Agreement") (Pl. Ex. 2 at Trial);

(5) the Sublet Agreement covered a twenty-month term and provided for: (a) Conklin to continue to maintain insurance and for the Debtor to reimburse him for its cost; (b) a per mile overage fee to be paid for excess milage; (c) monthly payments of $432.25, exclusive of insurance reimbursement; and (d) an option for the Debtor to purchase the Porsche for $16,800 at the end of the term;

(6) the Debtor paid as initial deposits and prepayments on the Sublet Agreement the approximate sum of $2,400.00;

(7) the Porsche continued to be registered to Conklin and have license plates which read "SUNGURU";

(8) on or about July 24, 1991, Conklin delivered a check to the Debtor in the amount of $3,550 to purchase from him ten thousand shares of Village Green common stock. The check bore a notation "10,000 shares 'book' @ .35". (Pl. Ex. 5 at Trial);

(9) the purchase price which the parties negotiated and which Conklin paid to the Debtor ($.35 per share) was a price between the bid and asked prices of the stock on the over-the-counter market. This price was represented by Conklin and the Debtor to be one which would allow the Debtor to obtain more for the sale of the stock than he could obtain by selling the stock through a broker and also allow Conklin to obtain the stock for a price less than he could otherwise obtain it through a broker;

(10) although on July 24, 1991 the Debtor owned more than 10,000 shares of Village Green common stock, he never delivered any stock to Conklin;

(11) the Debtor used the $3,550 paid by Conklin to purchase flower inventory by endorsing Conklin's check directly to a supplier;

(12) the Debtor never obtained a controlling interest in the Village Green, although it appears that he had been involved in negotiations with the controlling shareholder and had entered into various agreements which may have enabled him to accomplish this;

(13) the Debtor did not meet all of his obligations to Conklin under the Sublet Agreement, including making the required payments;

(14) on May 26, 1992, after numerous demands that the Debtor return the Porsche, representatives of Conklin picked up the Porsche at Exit 44 on the New York State Thruway where the Debtor advised Conklin and his representatives that it would be with the keys in it;

(13) when Conklin reobtained possession of the Porsche, it had external dents and scratches, several bald tires, a window which would not close, some ripped upholstery, a generally poor internal condition, damage to the center console and the exhaust pipe, and other damage;

(14) Conklin was required to expend substantial sums of money to bring the Porsche into the condition required under his lease agreement so that he could terminate the lease and return the Porsche to Porsche Financial.

DISCUSSION

I. Dischargeability of a Judgment for Frivolous Litigation

The Sanctions Judgment was entered in the State Court Action pursuant to 22 NYCRR Part 130.[3] Conklin has asserted that this Judgment is entitled to collateral estoppel effect and is

[3] N.Y. COMP. CODES R. & REGS. tit. 22, §130-1.1 (1989) provides:

(a) The court, in its discretion, may award any party or attorney in any civil action or proceeding before the court, except where prohibited by law, costs in the form of reimbursement for actual expenses reasonably incurred and reasonable attorney's fees, resulting from frivolous conduct as defined in this Part. In addition to or in lieu of awarding costs, the court, in its discretion may impose financial sanctions upon any party or attorney in a civil action or proceeding who engages in frivolous conduct as defined in this Part, which shall be payable as provided in section 130.3 [sic] of this Part. This Part shall not apply to town or village courts, to proceedings in a small claims part of any court, or to proceedings in the Family Court commenced under article 3,7,8 or 10 of The Family Court Act.

(b) The court, as appropriate, may make such award of costs or impose such financial sanctions against either an attorney or a party to the litigation or against both. Where the award or sanction is against an attorney, it may be against the attorney personally or upon a partnership, firm, corporation, government agency, prosecutor's office, legal aid society or public defender's office with which the attorney is associated and that has appeared as attorney of record. The award or sanctions may be imposed upon any attorney appearing in the action or upon a partnership, firm or corporation with which the attorney is associated.

nondischargeable as a debt resulting from wilful and malicious injury under Section 523(a)(6).

The Court agrees with Conklin that the Sanction Judgment, which was a final judgment not appealed by the Debtor and based upon an Order of Justice Plumadore which specifically found that the Debtor had engaged in "frivolous litigation", is entitled to collateral estoppel effect, and constitutes a debt resulting from wilful and malicious injury within the meaning and intent of Section 523(a)(6).

Recently, in *In re Colombo*, B.K. No. 93-21983, A.P. No. 93-2225 (Bankr. W.D.N.Y., December 20, 1994), the Court extensively discussed the collateral estoppel effect in the Second Circuit of final judgments entered in State Courts citing, in particular, *Kelleran v. Andrijevic*, 825 F.2d 692 (2d Cir. 1987), *cert. denied* 484 U.S. 1007 (1988) and *Mitchell v. National Broadcasting Company*, 553 F.2d 265 (2d Cir. 1977). These cases emphasize 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. At trial the Debtor asserted that he did not respond to the discovery demands and proceedings in the State Court Action which resulted in the Sanction Judgment because he thought the matter might be settled. However, the Debtor had a full

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(c) For purposes of this Part, conduct is frivolous if:

(1) it is completely without merit in law or fact and cannot be supported by a reasonable argument for an extension, modification or reversal of existing law; or

(2) it is undertaken primarily to delay or prolong the resolution of the litigation, or to harass or maliciously injure another.

Frivolous conduct shall include the making of a frivolous motion for costs or sanctions under this section. In determining whether the conduct undertaken was frivolous, the court shall consider, among other issues the circumstances under which the conduct took place, including the time available for investigating the legal or factual basis of the conduct, and whether or not the conduct was continued when its lack of legal or factual basis was apparent or should have been apparent to counsel.

(d) An award of costs or the imposition of sanctions may be made either upon motion in compliance with CPLR 2214 or 2215 or upon the court's own initiative, after a reasonable opportunity to be heard. The form of the hearing shall depend upon the nature of the conduct and the circumstances of the case.

and complete opportunity to respond to Conklin's motion in the State Court Action and he did not. Furthermore, Justice Plumadore specifically determined that the Debtor's actions constituted "frivolous litigation".

In this Court's view, a State Court's specific finding of frivolous litigation and the awarding of a judgment for costs and attorney's fees as damages for such frivolous litigation constitutes a wilful and malicious injury within the meaning and intent of Section 523(a)(6)[4], and such a judgment is nondischargeable. *See In re Zelis*, 161 B.R. 469 (9th Cir. BAP 1993); *In re Huber*, 171 B.R. 740 (Bankr. W.D.N.Y. 1994).

II. Stock Purchase Transaction.

As he did in the State Court Action, Conklin asserted in the Adversary Proceeding that the Debtor defrauded him in connection with his purchase of Village Green stock, and that his resulting damages, compensatory and punitive, should be determined to be nondischargeable.

That portion of the Dispositive Judgment which represents damages in the nature of principal, interest and appropriate costs and disbursements for the monies paid by Conklin to the Debtor for the purchase of 10,000 shares of Village Green common stock is determined to be nondischargeable under Section 523(a)(2)(A).

This Court has previously held in *In re Bohrer*, BK. No. 92-21223, A.P. No. 92-2094 (Bankr. W.D.N.Y. February 8, 1994) that in order for a creditor to prevail on a dischargeability count under this section, four elements must be proven by a preponderance of the evidence: (1) that the debtor

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[4] This Court has consistently held that wilful and malicious injury within the meaning and intent of Section 523(a)(6) is an act that was both wilful, deliberate or intentional, and malicious, wrongful and without just cause or excuse, even in the absence of personal hatred, spite or ill will. A debtor's conduct is malicious if he knew or should have known that the conduct would cause harm to the creditor.

made a false representation with the purpose and intention of deceiving the creditor; (2) that the creditor relied on the representation; (3) that the creditor's reliance was reasonably founded; and (4) that the creditor sustained the alleged damages and loss as a result of those misrepresentations. *In re Arguez*, 134 B.R. 55, 58 (Bankr. S.D.Fla. 1991).

At trial, the evidence indicated that the Debtor misrepresented to Conklin that he had 10,000 shares of Village Green common stock that he would sell and deliver to Conklin at a price that would be economically beneficial to both of them. At the time of the transaction, the Debtor owned at least 10,000 fully paid for shares of stock as represented, however, he never delivered any of the shares to Conklin. The evidence further indicated that the Debtor did not intend to deliver the stock to Conklin and that he made these false representations knowingly and with the intention to deceive Conklin so that he could obtain the agreed purchase price and immediately use it to buy flower inventory. The Court further finds that Conklin's reliance upon the Debtor's representations was reasonable on all of the facts and circumstances presented.

Those portions of the Dispositive Judgment which represents damages for the Debtor's failure to repurchase the 10,000 shares of Village Green common stock for $5,000.00 and for exemplary or punitive damages in connection with the stock purchase transaction are determined to be dischargeable.

Conklin alleged that the Debtor promised that he would repurchase the 10,000 shares of stock which he sold to Conklin for the sum of $5,000.00 in January, 1992, a time after which the Debtor represented he expected to have acquired a controlling interest in the Village Green. To the extent that in purchasing the Village Green stock Conklin claims to have relied on this representation or any of the Debtor's representations with respect to his ability to purchase a controlling interest in Village Green, the Court finds that Conklin's reliance was not reasonably founded.

Furthermore, lost profits are not money "to the extent obtained" by false pretenses, a false

representation or actual fraud as required by the specific language of Section 523(a)(2)(A).

Although there were no specific findings made by Justice Plumadore regarding punitive damages, only an order which granted them as requested in the Complaint, to the extent that Justice Plumadore awarded exemplary or punitive damages in connection with the stock transactions because the Debtor's fraud was blatant, such damages are also not for money, property or services "to the extent obtained" by false pretenses, a false representation or actual fraud, as required by the specific language of Section 523(a)(2)(A). *See In re Bugna*, 33 F.3d 1054, 1058-59 (9th Cir. 1994).

Furthermore, the Court does not believe that Conklin has proven by a preponderance of the evidence that the Debtor's conduct in connection with the stock transaction was a wilful and malicious injury within the meaning and intent of Section 523(a)(6). Such actions were at best a fraud under Section 523(a)(2)(A). In addition, there were no specific allegations made or proven that such damages were the result of fraud while acting in a fiduciary capacity, embezzlement or larceny under Section 523(a)(4).

To the extent that Conklin has asserted that such punitive damages, or portion of such damages, are nondischargeable under Section 523(a)(7)[5] because under Article 87 of the New York Civil Practice Law and Rules ("CPLR"), which was repealed after April 1, 1994, 20% of any punitive damage award is payable to New York State, this amount is only payable to the extent that

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[5] Section 523(a)(7) provides:

> to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty—
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> (A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or
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> (B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition.

the punitive damages are actually collected.[6] Since the Dispositive Judgment was never paid prepetition and the punitive damages portion has been found by this Court to be dischargeable so that the punitive damages will never be paid, CPLR Section 8703 is applicable and Section 523(a)(7) is, therefore, not applicable.

III. Obligations Under the Sublet Agreement

That portion of the Dispositive Judgment which represents damages in the nature of principal, interest and appropriate costs and disbursements, including attorney's fees, in connection with the Sublet Agreement, is determined to be dischargeable.

Conklin has asserted that the damages he suffered as a result of the Debtor's failure to comply with the terms and conditions of the Sublet Agreement are nondischargeable, either: (1) pursuant to Section 523(a)(2)(A), because they were for obtaining property or services by false pretenses, a false representation or actual fraud; (2) pursuant to Section 523(a)(4), because they were the result of fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny; or, in whole or in part, pursuant to Section 523(a)(6), because they were the result of a wilful and malicious injury by the Debtor to Conklin's property.

It does not appear that the provisions of Section 523(a)(4) apply on the facts and circumstances of this case, since there has been no embezzlement or larceny alleged or proven, and

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[6] Section 8703 of the New York Civil Practice Law and Rules provides:

> No amount of the twenty percent surcharge imposed pursuant to subdivision one of section eighty-seven hundred one of this article shall be collected until all costs, compensatory damages and attorneys fees have been paid. In the event that the full amount of a punitive damage award cannot be collected, the state shall be entitled to no more than twenty percent of the total amount of such punitive damage award that is collected by all parties.

the obligations which the Debtor had under the Sublet Agreement did not put him in a fiduciary capacity within the meaning and intent of Section 523(a)(4).

Although the amount of damages determined by Justice Plumadore in the State Court Action for the Debtor's breach of the provisions of the Sublet Agreement are entitled to collateral estoppel effect, this Court must determine whether Conklin has proven by a preponderance of the evidence that these damages are nondischargeable under Section 523(a)(2)(A) or Section 523(a)(6).

All of the allegations in the Complaint in the State Court Action in connection with the Debtor's failure to perform the terms and conditions of the Sublet Agreement sound in contract, not in fraud or in wilful and malicious conduct. Even with respect to some of the physical damage to the Porsche, Paragraph 92 of the Complaint alleged that "While the vehicle was in his possession, defendant allowed the vehicle to become damaged, as more particularly described in the schedule of repairs, annexed hereto as Exhibit B." (Exhibit B is the same as Plaintiff's Exhibit 6 at Trial which includes body shop work of $1,100.00 and other major items of damage which the Plaintiff has complained about in the Adversary Proceeding.)

After hearing the witnesses at trial, including Conklin and the Debtor, and having had the opportunity to assess their credibility, the Court believes that the Debtor did not enter into the Sublet Agreement without the intention to comply with its terms and conditions or to exercise the purchase option for the Porsche contained in the Agreement. The Debtor paid a substantial downpayment of in excess of $2,400.00, and in this Court's opinion reasonably believed that he would be able either to meet the terms of the Agreement or exercise the purchase option and acquire the Porsche as a result of his obtaining a controlling interest in the Village Green.

Although the issue has not been finally determined in the Second Circuit, this Court has consistently held that a creditor's reliance in connection with a Section 523(a)(2)(A) claim must be reasonable under all of the facts and circumstances presented. On the facts and circumstances of this

case, the Court believes that Conklin's investigation into the financial condition of the Debtor was woefully lacking, especially given his knowledge of the requirement by Porsche Financial to receive and review a detailed personal financial statement in connection with any prospective lessee of the Porsche. Conklin failed to obtain such a detailed personal financial statement, yet claims to rely on general oral representations made by the Debtor as to his businesses, assets and financial condition. Therefore, to the extent that there may have been any false representations made by the Debtor, which could otherwise be determined to be material on the facts and circumstances of this case, Conklin's reliance on them was unreasonable.

Further, from the pleadings and proceedings in this case, including the testimony of the witnesses and the evidence admitted at trial, including photographs of the Porsche (Pl. Ex.'s 14-21 at Trial), the Court does not find that Conklin has met his burden to show by a preponderance of the evidence that any of the internal or external physical damage to the Porsche was a wilful and malicious injury on the part of the Debtor within the meaning and intent of Section 523(a)(6). The external and internal damage is consistent with ordinary wear and tear for vehicles driven over 35,000 miles in Rochester, New York by many individuals. From the evidence, it appears that the Debtor utilized the Porsche in his everyday wholesale and retail florist business to transport inventory and make deliveries, and otherwise used and maintained it as a means of transportation. Clearly the Debtor did not use and maintain the Porsche with the reverence that Conklin previously had for it, and may have expected that any lessee of this or any Porsche would have for such a vehicle. However, there is insufficient evidence that the Debtor wilfully and maliciously caused any of the damage or that he failed to repair it within his means to do so. Furthermore, there is no evidence in the record as to when any of the various items of damage occurred, whether before or after the Debtor stopped making payments, demands were made for the return of the vehicle by Conklin, or when the Debtor knew that he would no longer be able to meet the terms and conditions

of the Sublet Agreement.

IV. Parking Tickets

That portion of the Dispositive Judgment which represents amounts paid by Conklin for parking tickets received and not paid for by the Debtor, together with interest and pro rata costs and disbursements, is determined to be nondischargeable pursuant to Section 523(a)(6).

The evidence presented at trial indicated that the Debtor previously had a driver's license suspended because of unpaid parking tickets incurred by his employees on a vehicle registered to him. Therefore, the Court finds that the Debtor knew that his failure to pay the parking tickets he received and failed to pay for when the Porsche remained registered in Conklin's name would result in Conklin having to pay the tickets or lose his driver's license or fail to be able to renew it.

CONCLUSION

The Sanction Judgment is determined to be nondischargeable under Section 523(a)(6).

That portion of the Dispositive Judgment which represents damages for the amounts paid by Conklin for parking tickets received by the Debtor and not paid for, together with interest and pro rata costs and disbursements, is determined to be nondischargeable under Section 523(a)(6).

That portion of the Dispositive Judgment which represents damages in the nature of principal, interest and pro rata costs and disbursements for the $3,550 paid by Conklin to the Debtor for the purchase of Village Green common stock is determined to be nondischargeable under Section 523(a)(2)(A).

Those portions of the Dispositive Judgment which represent lost profits and punitive damages in connection with Conklin's purchase of Village Green common stock are determined to

be dischargeable.

Those portions of the Dispositive Judgment which represent damages in the nature of principal, interest, pro rata costs and disbursements and attorney's fees, for the Debtor's breach of the Sublet Agreement, are determined to be dischargeable.

IT IS SO ORDERED.

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

Dated: March 8, 1995