UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In re

RICHARD F. COLLINS — Case No. 00-11547 K

Debtor

HI-QUAL ROOFING & SIDING MATERIALS, INC.

Plaintiff

-vs- — AP No. 00-1208 K

RICHARD F. COLLINS, personally and as the former president of COLDALE ENTERPRISES, INC., aka Rick Collins

Defendant

In re

CHRISTOPHER KARL RISDALE
former Vice President of
COLDALE ENTERPRISE, INC. — Case No. 00-21154 N

Debtor

HI-QUAL ROOFING & SIDING MATERIALS, INC.

Plaintiff

-vs- — AP No. 00-2165 K

CHRISTOPHER KARL RISDALE, a/k/a CHRIS RISDALE, personally and as the former Vice President of COLDALE ENTERPRISES, INC.

Defendant

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After the Plaintiff rested its case against these Defendants at trial,[1] and in light of apparent inconsistencies between the trial testimony of the Defendants and some evidence they provided in discovery, the Court invited a motion from the Plaintiff to amend the Complaint to add a § 523(a)(6) cause of action. That motion is now before the Court, vigorously opposed by the Defendants, who also seek dismissal of the actions on the grounds that the Plaintiff failed to make out a *prima facie* case against either of them on its § 523(a)(4) cause of action.

In light of the parties' respective briefs, the Court finds under Rule 15(b), Fed. R. Civ. P., that the Plaintiff's motion to amend should be granted in part and denied in part. Furthermore, the Court will herein grant the Defendants' motion to dismiss, in part, and deny it in part. Because further trial is necessary, the Court must be careful not to "lead" the further proceedings by saying too much. The somewhat cryptic analysis that follows will be enhanced at

[1]These are separate Adversary Proceedings that were never formally consolidated. Rather, they were pre-tried and tried together for the convenience of the parties.

the time of a final disposition.

I. Failure of the § 523(a)(4) Cause of Action

The 11 U.S.C. § 523(a)(4) Cause of Action that was pleaded is premised on the duty of a principal of an insolvent corporation to manage the corporation for the benefit of its creditors. (The crux of such an action is discussed later.) The Plaintiff here was a creditor of Coldale Enterprises, Inc., and the Defendants were the two principal officers/directors/owners of Coldale.

Here, however, the Plaintiff's own evidence is that the Plaintiff was not a mere "creditor" of Coldale. Rather, there came a time when Plaintiff took substantial control of Coldale's activities: It decided on a weekly basis (if not even more frequently) what accounts payable of Coldale needed to be paid, making loans of cash to Coldale as needed to cover those payments; it obtained personal guarantees of the Defendants; it took possession of payment checks received by Coldale on its receivables; it discussed long- and short-term strategies for Coldale including looking for work in Florida; and it stayed apprized of work in New York that Coldale was bidding.

These activities by the Plaintiff came about because by the time Plaintiff was owed approximately $150,000 by Coldale, Plaintiff knew that Coldale was insolvent or on the verge of insolvency, and Plaintiff decided to keep Coldale "alive" in hopes of eventually collecting what it was owed. The Plaintiff lost a second $150,000 in that effort. Although there

can be no doubt about the fact that in the State of New York a corporate director has a duty of faithful conduct to corporate creditors, and that that duty arises upon insolvency,[2] one who takes control of the corporation "buys" into a state of affairs that places others at risk. Specifically, if I were a person who extended credit to Coldale while HiQual kept Coldale "alive" for HiQual's own purposes, I might look to HiQual if a subsequent Coldale bankruptcy left me unpaid. From my perspective, Coldale looked "healthier" than it really was. For my sake, it should have closed its doors sooner rather than later, and HiQual is to blame.

In fact, there never was a Coldale bankruptcy, and so there is no evidence of whether the Article 9 liquidation that did occur, did or did not leave any trade creditors unpaid. But case law under 11 U.S.C. § 510 makes it clear that when a lender begins controlling a borrower (and there can be no doubt about the fact that HiQual became a lender and a controlling entity under 11 U.S.C. § 101 (101(2)(D)) and not just a trade creditor),[3] it may find itself standing in line behind the "mere" creditors to which the director of a corporation owes an active duty of faithful conduct . See 14A N.Y. Jur. 2d Business Relations § 1084. [citations omitted] 1996.

HiQual got itself secured, guaranteed, and in control. It made Coldale toe-the-mark. This lawsuit is about the fact that it failed to get the two principals of Coldale to toe-the-mark. Even if HiQual could show that it paid all other creditors of Coldale, it may not rely on a duty that the Defendants owed to Coldale's creditors "at large." The § 523(a)(4) Cause of Action

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[2] 14A N. Y. Jur. 2d, Business Relationships § 684 (1996).

[3] This is not a holding that the line of credit agreement constituted an "operating agreement" but there can be no doubt about the fact that HiQual became an "insider" by virtue of control of the Debtor under 11 U.S.C. § 101(2)(D), (31) (B)(iii) and (31)(E).

fails.[4]

II. THE RULE 15(b) MOTION TO AMEND

If the Plaintiff is allowed to amend to claim that the Defendants wilfully and maliciously injured HiQual once HiQual took charge of Coldale,[5] then this Court would find, from the evidence, that a *prima facie* case has been made out to a sufficient extent against each Defendant. Therefore, the permissibility of the amendment must be decided.

The language of Rule 15(b) is, of course, the place to start. As to events prior to the time that HiQual began to control Coldale, the Court finds that the question of possible "wilful and malicious injuries," which were "not raised by the pleadings," were not in fact "tried by express or implied consent of the parties." Moreover, the Court is satisfied that it would prejudice the Defendants for the Court to permit the amendment as to those events, even if the Court were to grant a continuance to enable the Defendants to conduct further discovery and otherwise to defend an amended complaint on the merits. On the other hand, it is clear that allegations of culpable conversions of physical assets of Coldale and of corporate opportunities

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[4]It is possible that a "new" fiduciary relationship arose after the HiQual takeover of Coldale - - one like that among joint venturers. See, for example, 16 N.Y. Jur. 2d Business Relationships § 1955 (1996). But that has not been pled.

[5]For the same reason that the "fiduciary fraud" claim failed, the proposed amendment must fail as to any "wilful and malicious injury" prior to HiQual's takeover of Coldale. HiQual did not take over Coldale to preserve HiQual's claims against Collins and Risdale as to past wrongs; it took Coldale over to operate it for HiQual's benefit, and must be charged with having "accepted" the conditions it found or could have found. All of that being said, however, this decision will rest upon the view that Rule 15(b) defeats the proposed amended as to the pre-takeover period.

of Coldale after HiQual's takeover of Coldale, were in fact litigated.

A. The Issue

The parties' briefs raise matters of which the Court was not aware at the time it invited the motion to amend the complaint to conform to the evidence. (The Court's extensive involvement in pre-trial matters in these cases addressed whether and when the Defendants must present themselves, and not the "what" - - not the substance of the evidence that was being produced at discovery.) In their briefs, the Defendants argue that they made many legitimate choices during pre-trial proceedings in reliance on the fact that only fiduciary fraud had been pled. Among the choices was the choice not to seek separate trials, not to employ separate counsel, and to not cross-claim against each other. And as to the merits, they argue that when they were accused of fiduciary fraud only, they stood together because they each stood in the same legal relationship to the Plaintiff, and a complete defense would lie in establishing that they in fact were not fiduciaries as to HiQual, and that, in any event, HiQual did not rely on any relationship of "trust" as to the matters and periods of time at issue. According to the Defendants, the subjective intent of either of the Defendants was irrelevant under the original complaint, given what the Plaintiff knew about the Defendants and given the Plaintiff's familiarity and control of Coldale's affairs.

But to permit an amendment to add a § 523(a)(6) cause of action, the Defendants assert, would be to pit them against each other because there is no *prima facie* case that they

were alter egos or otherwise acted with one mind as to any intentional injuries.

B. The Defendants Must Prevail, Up to a Point

The Court agrees with the Defendants' arguments up to a point. The various permutations of the arguments are set forth fully by Defendants' counsel, and those would be adopted by the Court were it not for the fact that the arguments are couched in terms of the Defendants' own interpretation of the evidence adduced at trial, rather than upon objective analysis. The Court offers the following analysis of the questions, independent of the allegations and the evidence adduced in this case.

The first question under Rule 15(b) is whether the elements of "wilful and malicious injury" were in fact "tried by express or implied consent of the parties," even though they were "not raised by the pleadings." To this writer, this is tantamount to asking whether the factual elements of "wilful and malicious injury" were "actually litigated" not only in the presentation of the Plaintiff's case, but in the pre-trial proceedings. Stated otherwise, would a shift from "breach of fiduciary duty" to "wilful and malicious injury" be in all regards a qualitative and substantive shift, and not merely a different perspective on facts that were actually or impliedly at issue in the litigation?

To answer this question, consider an illustration that is wholly removed from the allegations of the case at bar. If Buyer B purchases a replacement bathtub from Seller S to be installed in B's home, and after it has been installed by B there is a leak that ruins the floor under

the tub and ruins the ceiling underneath, B might sue S for faulty installation. S might claim that the tub was installed in a workmanlike fashion and that the fault lay elsewhere. At trial, B might learn for the first time that the tub was unsuitable for the job; it was too heavy and too large for the purpose. B might then move to amend to allege breach of implied warranty. It can be seen that on the original complaint in this hypothetical the sole issue would be the present condition of the property - Is it presently seen that the tub was installed in a workmanlike condition? But under the amended theory, a suitable defense might involve the details of the initial transaction between Buyer and Seller. Did B do his or her own measuring of the space and mismeasure it? Did S provide a selection of tubs to B and what choices did B make in light of any weight or size limitations or specifications explained by S at the time? Did B alter the site after the deal was struck by having other work done on the site that might have been incompatible with what had been planned or agreed between B and S? And so forth.

If a statute of limitations has passed between the time the original complaint was served and the time that a plaintiff seeks to amend to conform to the evidence, serious issues are presented that are well-examined by the published cases. But issues nearly as serious are presented even if the limitations period has not run; not just Due Process questions, but questions of fairness and equity that are not well examined in the published cases. For example, Seller might have since laid-off or discharged the salesperson that Buyer dealt with, Seller previously having had no reason to know that the salesperson's truthful testimony might be necessary to establish that the fault lies in Buyer's own actions or representations. Any documents that might have memorialized the interaction between Buyer and Seller at the time of sale may have been

routinely discarded, whereas they would surely have been preserved if breach of warranty had been asserted in the first place, rather than faulty installation alone.

Such possibilities serve the dual purpose of demonstrating (1) how different are the issues raised by what was and was not originally pleaded, and (2) the prejudice that would result from permitting the amendments even if the seller were given an adjournment and a reopening of discovery to attempt to defend itself against the merits of the amended claim.

When we use the bathtub hypothetical but add the fact that installation was done by the seller's independent contractor C, the matters become more difficult. If both S and C are sued by B and the issue was whether there was faulty installation, a complete defense might rest in expert testimony regarding the present condition of the bathtub and its appurtenances, and S and C may stand in support of one another. But if an amendment is permitted to plead breach of warranty of fitness, S and C may have claims over against each other, and any attempt to establish those defenses or cross claims may stand at odds with their prior effort to bolster each other in defense of the original action. And this circumstance would exist whether they had separate counsel or not - - there would be no reason for counsel to bring in other counsel to preemptively defend a yet unpled cause if that defense would require one defendant to undermine his or her own argument that the co-defendants[6] had trust and confidence in each other toward serving their mutual customer.

Some evidence that might be sufficient to establish a claim of "wilful and

[6]Again, these are not really co-defendants. These are separate cases, tried together for the convenience of the parties.

malicious injury" was adduced at trial here, but Rule 15 requires that that is not a basis upon which to permit amendments to the extent that the elements of that cause were neither impliedly nor expressly litigated. And the fact that the two defendants could have utilized separate representation and could have sought separate discovery and separate trials is not important. Just as a plaintiff, in drafting a complaint, is not expected to plead to anticipated defenses, co-defendants are not required, in making key decisions regarding defenses and representation of counsel, to defend against all possible changes in a plaintiff's theory.

C. In Part, However, The Motion Will Be Allowed

Such argument breaks down, however, to the extent that the actual interaction between the bathtub Buyer and the Seller, as well as the actual interaction between the Buyer and the Contractor, were actually litigated.

For example, if Seller and Contractor attempt to defend what might otherwise appear to be shoddy installation by laying the blame at B's own feet, then S and C may not complain if what grows out of the resulting evidence is a clear breach of promise or warranty, and if leave is granted to amend the Complaint accordingly.

In the case at Bar, the Defendants argued to the Court, virtually from the moment they were served with the Complaint (they responded with Motions to Dismiss instead of Answers), that they could not understand HiQual's allegations because HiQual always had all the information that HiQual was claiming had been hidden from it. Not until trial was the Court

aware of HiQual's involvement in the operations of Coldale. It is because of that involvement that the Court has now granted dismissal of the § 523(a)(4) Cause of Action.

But consider, again, the bathtub. If S and C were to argue that they cannot understand a claim of faulty installation because they each discussed with B the various problems they were having about the tub as those problems were arising, they may not complain about B's request to change the theory of recovery to one based upon those discussions. In the present case, the very interactions that defeat the particular fiduciary relationship that was pled necessarily gave rise to questions of culpable conversion or other wilful or malicious injury once HiQual began to interact with each Defendant individually, after the take-over.

Defendants actively litigated their individual conduct with respect to HiQual and Coldale after the take-over, and the Motion is granted as to those events.

HiQual has made out a *prima facie* case of wilful and malicious injury by each defendant separately, after the takeover, and the Defendants may defend separately or together, as they might choose.

A telephonic pretrial will be initiated by the Court on **December 21, 2001, at 9:00 a.m.**, to ascertain whether the presentation of the Defendants' cases will be consolidated or severed; whether any further discovery is necessary or appropriate AS BETWEEN THE DEFENDANTS ONLY;[7] and to determine the dates and times for the presentations.

[7]The Plaintiff has rested.

The Complaints are deemed amended accordingly, and dismissed in part. No Answers are required as to the Amended Complaints.

SO ORDERED

Dated: Buffalo, New York
November 29, 2001

/s/ Michael J. Kaplan

U.S.B.J.