UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In re

MICHAEL R. PALMER — Case No. 99-17039 K

Debtor

WASHINGTON INTERNATIONAL INSURANCE CO., individually and on behalf of all others similarly situated

Plaintiff

-vs- — AP No. 00-1205 K

MICHAEL R. PALMER

Defendant

The Plaintiff brought this Adversary Proceeding seeking, in part, judgment under 11 U.S.C. § 523(a)(4) based upon alleged violations of Article 3-A of the New York Lien Law. The Debtor argues that Plaintiff's claims do not fall within the scope of Article 3-A and raises numerous affirmative defenses. At the initial pre-trial conference, Debtor's attorney argued first and foremost that the Debtor could demonstrate that he was not out-of-trust. As a result, the Court limited discovery to allow the Debtor the opportunity to provide evidence to support that position.

Specifically, the Court ordered that the "Debtor is directed to provide . . . all the information that he would provide in response to a Lien Law § 76 demand, if this were a non-

bankruptcy proceeding." (Order dated August 8, 2000).

A further pre-trial was held and Plaintiff's counsel argued that the Debtor's records were inadequate, and insisted on a right to bring a summary judgment motion. The Court entered a scheduling order stating that "Debtor shall serve . . . any additional materials . . . in compliance with [the 8/8/00 order] no later than January 26, 2001." The Order directed that Plaintiff bring "a summary judgment motion based solely on the question of whether the Debtor's response to the Court's August 8, 2000 Order would entitle Plaintiff to summary judgment because (in the Plaintiff's view) proper application of New York Lien Law to a 11 U.S.C. § 523(a)(4) action would require incorporation of the State Law evidentiary burdens and presumptions pertaining to the rights of the Lien Law beneficiaries . . . ." Otherwise, the question would be "deemed waived as a pretrial matter" and "precluded until after a trial on the merits of the case." (Order dated January 11, 2001). The Plaintiff subsequently served a motion for partial summary judgment and Debtor has submitted a reply.

The statutory schema of the Lien Law has both a substantive and an evidentiary element. If you are out-of-trust, you have breached a fiduciary duty and you are guilty of a crime. N.Y. Lien Law § 79-a (McKinney 1993). That is the substantive element. If you fail to keep trust fund records in the manner provided by § 75(3) of the Lien Law, there is a presumption that you are out-of-trust. N.Y. Lien Law § 75(4) (McKinney 1993).

Because this Plaintiff issues construction-industry performance or completion bonds, it would be useful to the Plaintiff to establish that a breach of the duty to maintain trust fund records in the manner prescribed by state statute is itself a "stand alone" fiduciary fraud

under 11 U.S.C. § 523(a)(4). Were this true, Plaintiff could avoid tedious and expensive discovery and trial in all dischargeability cases in which the Debtor, according to state law, is presumptively out-of-trust.

And if that is true, it creates an odd "warp" in Rule 56 practice (Fed.R.Civ.P. 56), for it would say that most of Rule 56 doesn't apply at all - - the only adequate response to a Rule 56 motion would be a dispositive response, i.e., "I did keep proper records. Here they are and they prove I was not out-of-trust."

No other form of response could create a "triable issue" of fact.

To frame the issue this way is to answer it. Discharge issues are federal law issues. Although the substantive state law has been incorporated into § 523(a)(4) by the judicial gloss on that provision, there is no basis in bankruptcy law specifically, or in federal law generally, to elevate an evidentiary requirement of state law which merely deals with presumptions (and, therefore, the duty to go forward) into an ironclad barrier that writes Rule 56 off the books.

The Plaintiff's argument, if sustained, would result in the bizarre circumstance that a debtor who could rebut the presumption to the point of an absolute certainty that he was not out-of-trust, and who would be permitted to do so in a criminal prosecution in state court, automatically loses a Rule 56 Motion in § 523(a)(4) litigation because his proof is a form that is not that contemplated by Lien Law § 75.

The Court finds that the evidentiary element of the Lien Law is not itself a separate fiduciary duty. Rather, it is merely an evidentiary device to assist the Lien Law

beneficiary. This Court finds it appropriate to expropriate the presumption into § 523(a)(4) litigation, but not to elevate it to the level of a substantive fiduciary fraud all of its own.

The Debtor may defend the Rule 56 Motion by any means provided in Rule 56.

That being said, the Debtor has not done so. Rather, the Debtor's counsel argues that this Court's prior orders were reasonably interpreted as not necessitating a traditional Rule 56 reply. And counsel explains that the voluminous proof that the Debtor would offer, is "trapped" in a computer that needs repairs that he is willing to pay for, if he will be permitted to offer it.

Moreover, the Debtor now wishes to change the direction of pre-trial proceedings. So far, the Court has focused on the Debtor's proof that he was not out-of-trust because the court was assured that Debtor could provide that proof, laying the matter to rest. Now the Debtor wishes instead to argue the Affirmative Defenses he interposed - - that Plaintiff might not be a Lien Law beneficiary, that fraud was not pled with particularity, that Plaintiff's claim is time-barred, etc.

It being clear that the Court's effort to assist the parties in finding the most expeditious route to a proper disposition of this matter was misguided, the Debtor's prayer in ¶ 50 of his Reply is granted. The Court agrees that the prior Orders did not permit, let alone require, a traditional Rule 56 response.

The Plaintiff's Rule 56 Motion is denied without prejudice for the reasons stated above. Full discovery shall proceed. The deadline for discovery shall be June 1, 2001.

A further telephonic pre-trial shall be conducted on **June 18, 2001 at 2:00 p.m.**

SO ORDERED.

Dated: Buffalo, New York
March 19, 2001

/s/ Michael J. Kaplan

U.S.B.J.