UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

ROBIN HADLEY, a/k/a
ROBIN BEACH and
JOSEPH HADLEY — CASE NO. 93-6l260

Debtors

QUALITY HOMECARE SERVICES,

Plaintiff

vs. — ADV. PRO. NO. 93-70l48A

ROBIN HADLEY and
JOSEPH HADLEY,

Defendants

APPEARANCES:

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STEPHEN D. GERLING, U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER

This adversary proceeding was commenced against the debtors herein, Robin Hadley and Joseph Hadley ("Debtors"), by the Plaintiff, Quality Homecare Services ("QHS") to determine the dischargeability of a debt due and owing to QHS pursuant to §523(a)(2) of the Bankruptcy Code (11 U.S.C. §§101-1330) ("Code").

QHS's complaint also references Code §727, but the original complaint sought relief only with regard to Code §523(a)(2).

A trial of the adversary proceeding was commenced and concluded on January 6, l994 at Utica, New York. At the trial QHS orally moved pursuant to Rule 70l5 of the Federal Rules of Bankruptcy Procedure ("Fed.R.Bankr.P"), which incorporates by reference Rule l5 of the Federal Rules of Civil Procedure ("Fed.R.Civ.P."), for permission to amend its complaint by adding a second cause of action pursuant to Code §523(a)(4). The Court reserved on QHS's motion and provided both parties with an opportunity to file memoranda of law on or before February 2, l994.

JURISDICTIONAL STATEMENT

This Court has jurisdiction over the parties and subject matter of this core adversary proceeding pursuant to 28 U.S.C. §§1334(b) and l57(a), (b)(l), (b)(2)(I).

FACTS

QHS, a branch of NMC Homecare, provides medical care services and supplies at a patient's home. In January l993, the Debtor, Robin Hadley ("R.Hadley"), became a patient of QHS while recovering at her home from pneumonia and an abscessed lung.

At the time of her referral to QHS by her attending physician, R.Hadley had health insurance coverage through Group Health Incorporated ("GHI"). (See QHS Exhibits l and 2). On or

about January l8, l993, R.Hadley executed an "Assignment of Insurance Benefits and Release of Information" form authorizing GHI to pay benefits on her behalf for treatment and supplies rendered by QHS, directly to QHS. (See QHS Exhibit 3).

Thereafter, QHS rendered services and supplies in the nature of intravenous and antibiotic therapy to R.Hadley during the period January l8, l993 through February l2, l993 at a total cost of $l4,84l. In connection with those services, invoices were submitted to GHI by QHS during the period January 30, l993 through March l, l993. (See QHS Exhibit 4).

Thereafter, GHI issued five checks payable only to R.Hadley in connection with the services and supplies provided by QHS. R. Hadley received four of the checks during the second and third weeks of March l993. The fifth check was received in the later part of April l993, at or about the time Debtors filed their voluntary petition in bankruptcy.[1]

At the time R.Hadley received the four checks in March l993, she had not received any bill from QHS, however, she did receive a phone call from a representative of QHS in mid-March inquiring as to whether she had received any checks from GHI. R.Hadley advised QHS that she had received checks and requested a bill. Within a short time thereafter, she was provided with a bill from QHS totalling $l4,84l.

R.Hadley, with the cooperation of her father, Robert Beach, and the Debtor, Joseph Hadley, cashed all five of the GHI

[1] It is not clear to this Court from the evidence presented why GHI failed to honor the Assignment and forward the benefit checks directly to QHS.

checks and received the cash. R.Hadley used the cash for various living expenses but paid no part of the proceeds to QHS. At the time the checks were cashed, R.Hadley knew she had assigned her health insurance benefits to QHS, and she was of the opinion that the proceeds of the GHI checks belonged to QHS.[2]

R.Hadley and her husband, Debtor Joseph Hadley, filed a voluntary petition in bankruptcy pursuant to Chapter 7 of the Code, on April 26, l993.

ARGUMENTS

QHS initially asserts that it should have been permitted to amend its complaint at trial to add a cause of action grounded upon Code §523(a)(4), alleging that R.Hadley's actions in cashing the five checks from GHI and failing to turnover the proceeds to QHS constituted embezzlement. QHS contends that the addition of the Code §523(a)(4) cause of action in no way prejudices the Debtors since it merely adds a theory of law to the facts presented at trial. QHS points out that neither party conducted any pre-trial discovery or motion practice in which specific theories of law were advanced, and the Court permitted both parties to submit post-trial memoranda of law in order to brief their respective positions.

QHS argues that under either Code §523(a)(2)(A) or

[2] Plaintiff's Exhibit 4 received in evidence contains copies of the five checks sent to R.Hadley by GHI as reimbursement for the cost of services rendered by QHS. While, for the most part, the checks are illegible, the bank coding on four of the checks indicates the total amount of those four checks was $7,632.49.

(a)(4), the Debtors should be denied a discharge of the debt owed QHS since they intentionally and fraudulently negotiated and appropriated the GHI checks to their own benefit when they knew that the proceeds of the checks belonged to QHS.

Debtors contend that QHS should not be permitted to amend its complaint since had Debtors been aware of the second cause of action based upon §523(a)(4), they would have submitted additional proof at trial and cross-examined QHS's witnesses differently.

Debtors argue that they anticipated that any payment by GHI would have been made directly to QHS since they believed that QHS was a participant in GHI and that they never expected to receive any checks from GHI. R.Hadley testified that at the time she received the first four GHI checks, she had not received a bill from QHS and upon receipt of the bill, she realized that the payment from GHI would be grossly inadequate to pay QHS in full, thus she did not remit any payment to QHS.

Debtors also assert that at the time R.Hadley contracted with QHS for its services and assigned her GHI benefits, she had no intention of defrauding QHS and that her later use of those benefits in the form of the five checks to meet her personal living expenses did not result from any intent to deceive QHS.

DISCUSSION

The Court must first consider QHS's motion pursuant to Fed.R.Bankr.P. 70l5 to amend its complaint to assert a second cause of action based upon Code §523(a)(4) alleging embezzlement.

Fed.R.Bankr.P. 70l5 incorporates by reference Fed.R.Civ.P. l5, which governs the amendment of pleadings both before and after trial. See Fed.R.Civ.P. l5(a) and (b). In the instant adversary proceeding, the amendment proposed by QHS is governed by Fed.R.Civ.P. l5(b) and is properly considered as a motion to conform the pleadings to the evidence, a motion that may be made at any time, even after judgment.

It is to be noted that QHS's attorney attempted, at the opening of the trial, to move to amend its complaint, and the Debtors' attorney generally objected. However, the Court directed both attorneys to delay argument on the QHS motion until the close of proof, and it would be treated at that time as a Fed.R.Civ.P. l5(b) motion. Thus, while it cannot be said that Debtors consented to the trial of QHS's complaint as it was proposed to be amended at the close of the proof, the central issue to be considered by this Court is "whether the opposing party had a fair opportunity to defend and whether he could have presented additional evidence had he known sooner the substance of the amendment. Hardin v. Manitowac-Forsythe Corp., 69l F.2d 449, 456 (l0th Cir. l982); see also Matter of Prescott, 805 F.2d 7l9, 725 (7th Cir. l986); In re Gunn, lll B.R. 29l (9th Cir. BAP l990).

It has been held within a bankruptcy context that "[t]he fact that the amendment changes the legal theory of the action is immaterial so long as the opposing party has not been prejudiced in the presentation of its case." Matter of Nett, 70 B.R. 868, 87l (Bankr.W.D.Wis. l987). In Nett, Bankruptcy Judge Robert Martin denied the debtors' discharge at the conclusion of trial pursuant

to a cause of action which had not been pled. The debtors argued in a motion for reconsideration that they had been denied due process of law. Judge Martin concluded that the evidence at trial supported the Court's finding that the debtors had violated Code §727(a)(5), though that section of the Code had not been included in the complaint before the court. He also concluded that the allegations of the complaint were "sufficient to put the debtors on notice that they would be asked to explain what they had done with the proceeds from the sales of these various assets." Id. at page 873. Finally, Judge Martin concluded, "Furthermore, it is unclear what additional evidence the debtors could offer to refute the Section 727(a)(5) discharge objection since they were given full opportunity at trial to explain the disappearance of the assets and loss of the proceeds therefrom." Id. at 874.

Likewise, in the adversary proceeding before this court, the complaint put the Debtors on notice of what QHS alleged as the basis for excepting its debt from their discharge. The proof offered by QHS at trial did not differ from what was alleged in the complaint, to wit: that R.Hadley was a patient of QHS and received treatment from January l, l993 to February l2, l993, that R.Hadley was paid for a portion of those services by her health insurer, GHI, and that she, in turn, failed to pay QHS and failed to list the funds received in her voluntary petition.

All that QHS sought to add was an additional cause of action alleging embezzlement pursuant to Code §523(a)(4). Debtors argue that had they been aware of this additional cause of action, they would have called witnesses, submitted additional proof and

cross-examined QHS's witnesses differently. Debtors, however, do not provide any specifics, and the Court is unable to accept Debtors' argument that they were somehow prejudiced by the addition of the Code §523(a)(4) cause of action.

The factual scenario QHS provided through the witnesses it called, and the documentary evidence it produced, would have been no different had QHS continued to rely solely on its Code §523(a)(2)(A) cause of action. The Debtors cannot now assert prejudice because they chose not to call any witnesses or produce any documentary evidence. The Court is at a loss to identify what witnesses or what proof Debtors would have produced had they been aware, from the outset, that QHS was relying as well on the embezzlement element of Code §523(a)(4). Thus, the Court will grant QHS's motion to amend its complaint pursuant to Fed.R.Bankr.P. 70l5 and Fed.R.Civ.P. l5(b).[3]

Turning to the merits, QHS alleges both fraudulent misrepresentation and embezzlement on R.Hadley's part. It should be noted, at the outset, that there is no proof before the Court that would suggest that the Debtor Joseph Hadley engaged in any conduct which would result in a denial of his discharge from the QHS debt. The only testimony linking Joseph Hadley to the actions of his spouse is that he cashed one of the GHI checks on R.Hadley's behalf, and turned over the proceeds to her. There is no indication that he was contractually obligated to QHS or that any of the GHI checks were payable to his order, or that he assisted

[3] The Court notes that by virtue of QHS's effort to amend its complaint prior to trial, the Debtors were alerted at that point that QHS intended to assert an additional cause of action.

R.Hadley in actually diverting the check proceeds to payments of parties other than QHS. Thus, the Court must dismiss the complaint as to Debtor Joseph Hadley.

The law is well-established that in order to establish a Code §523(a)(2)(A) cause of action, the plaintiff must prove five factors as follows: 1)debtor made false representation to creditor; 2) debtor made the representation knowingly and fraudulently; 3) with an intent and purpose to deceive the creditor; and 4) the creditor relied upon such representation to its detriment. In re Kirsh, 973 F.2d l454 (9th Cir. l992); In re Brossard, 74 B.R. 730, 737 (Bankr. N.D.N.Y. l987).

It is also fairly well established that a debtor's promise to perform a future act is not a false representation or false pretense under Code §523(a)(2)(A) unless it can be shown that at the time the debtor made such promise it had no intention of fulfilling same. See In re Gans, 75 B.R. 474 (Bankr. S.D.N.Y. l987).

Proof of the debtor's intent can only be gleaned from the totality of circumstances, portraying "a picture of deceptive conduct by the debtor, which indicates that he did intend to deceive and cheat the lender." In re Brossard, supra, 74 B.R. at l37.

Applying these principles to the proceeding sub judice, this Court cannot reach the conclusion that on January l8, l993, when R.Hadley executed the Assignment of her GHI benefits to QHS, she harbored any intent to defraud QHS. In fact, R.Hadley testified that she believed QHS was a participant in GHI, and based

upon her prior experience, she believed that GHI would pay QHS directly. It was only after R.Hadley had received the checks directly from GHI that she reached a determination not to remit the checks or their proceeds to QHS. Thus, the Court concludes that QHS has not established the fraudulent misrepresentation necessary to deny dischargeability of R.Hadley's debt to QHS pursuant to Code §523(a)(2)(A). See ITT Fin. Servs. v. Hulbert, l50 B.R. l69 (Bankr. S.D.Tex. l993).

Thus, the Court must turn to QHS's second cause of action grounded upon Code §523(a)(4). QHS asserts that R.Hadley's actions in cashing the GHI checks and using the proceeds to pay other obligations constituted embezzlement. For purposes of Code §523(a)(4), embezzlement is said to exist when a plaintiff proves that the debtor has misappropriated property in which it has an interest, which property has been entrusted to the debtor or has lawfully come into the debtor's possession and said misappropriation results from fraud in fact, involving moral turpitude or intentional wrong. See In re Black, 787 F.2d 503 (l0th Cir. l986); 26 Am.Jur.2d Embezzlement §8.

QHS cites the Court to In re Catalano, l98 B.R. l68 (Bankr. W.D.N.Y. l989), where on similar facts, former Bankruptcy Judge Edward D. Hayes concluded that a medical provider to whom the debtors had assigned their health insurance benefits had not made out the necessary fiduciary relationship to render the debt that arose from the debtor's misappropriation of the insurance benefit checks nondischargeable pursuant to Code §523(a)(4). QHS opines that had the medical provider grounded its dischargeability

complaint on embezzlement rather than "fraud or defalcation while acting in a fiduciary capacity," it would have been successful as QHS should be herein. There is, however, no dicta in Catalano to suggest that QHS's analysis is correct.

It is clear, however, that generally one cannot embezzle one's own property. Thus, the Court must first focus on the initial element of embezzlement that allegedly the GHI checks were not solely the property of R.Hadley at the time they were received. See In re Belfry, 862 F.2d 66l (8th Cir. l988). Under New York law, an assignment is defined as "a transfer or setting over of property or of some right or interest therein, from one person to another, and unless in some way qualified, it is properly the transfer of one's whole interest in an estate, or chattel, or other thing." 6 NYJur.2d Assignments §l. However, while the

> assignment of a claim not in existence is valid and enforceable in equity when supported by good consideration, the assignee's interest is only an equitable interest or lien and can be enforced only in equity. Thus, an assignment of property to be acquired in the future does not vest title in the assignee even when the property comes into the control of the assignor. At that time, title vests in the assignor subject to the assignee's lien; there is no transfer of title to the assignee until the assignor surrenders possession or the lien is enforced by judicial decree.

Id. at §20. See also In re Musser, 24 B.R. 9l3, 9l9 (W.D.Va. l982).

It is clear, however, that one who holds less than absolute title to property can be the victim of embezzlement within the meaning of Code §523(a)(4). Case law which has examined the concept of embezzlement as a basis for nondischargeability, appears to generally support the conclusion that it is the federal

definition which controls. See In re Hoffman, 70 B.R. ll5, l62 (Bankr. W.D.Ark. l986); In re Sutton, 39 B.R. 390, 395 (Bankr. M.D.Tenn. l984). That definition, as previously indicated, simply requires a "fraudulent appropriation of property by a person to whom such property has been entrusted or into whose hands it has lawfully come." Id. at 395. While other courts have correctly observed that one cannot embezzle ones own property, the fact of ownership appears to pale in the face of circumstances which clearly indicate the intent of the debtor to grant specific rights to a third party in property otherwise in the lawful possession of the debtor.

In Hoffman, supra, the court concluded that the debtor embezzled from his secured creditor when he sold farm equipment pledged as security to the creditor and failed to turn over the proceeds. The court engaged in very little discussion of the element of debtor's ownership. Likewise in In re Russell, l4l B.R. l07 (Bankr. W.D.La. l992), the bankruptcy court found that a debtor husband had embezzled a portion of his U.S. Army retirement benefits which had been awarded to his wife in a pre-petition matrimonial action when he received those benefits and failed to turn over the required portion to his spouse. The court concluded that the spouse had acquired an ownership interest in the retirement benefits by virtue of the matrimonial court's award, even though the debtor was lawfully in possession of the benefits. See also In re Valentine, l04 B.R. 67, 7l (Bankr. S.D.Ind. l988).

In the case sub judice, while it is apparent under New York law that the Assignment executed by R.Hadley was equitable in

nature and did not pass actual legal title to QHS, it did create a sufficient interest in QHS so as to establish a claim of embezzlement within the meaning of Code §523(a)(4) when R. Hadley subsequently received and applied the GHI proceeds to the detriment of QHS.[4]

The second element, that of misappropriation, is clearly met by R.Hadley's admission that she did not remit any of the proceeds of the GHI checks to QHS, but in fact utilized the proceeds to pay day-to-day bills. It is of little consequence that at the time she received the first four checks from GHI she had not yet received a bill from QHS since by her own admission, she was aware that she had previously assigned the GHI benefits to QHS.

The final element of embezzlement, that being the finding of a fraudulent intent involving moral turpitude, is perhaps the most difficult to establish, since it must be kept in mind that exceptions to discharge are to be narrowly construed in a debtor's favor so as to enforce the fundamental bankruptcy policy of assuring the debtor of a fresh start. See Belfry, supra, 862 F.2d at 662, and Catalano, supra 98 B.R. at l69.

It has been frequently observed that a fraudulent intention can only be gleaned from external action, as well as circumstantial evidence, and that is no less true in the case of embezzlement. See Brossard, supra, 74 B.R. at 737; In re Bevilacqua, 53 B.R. 33l, 334 (Bankr. S.D.N.Y. l985). In the

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[4] Courts recognize that a pre-petition equitable assignment is sufficient to divest a debtor's estate of the proceeds which arise post-petition. In re Billy H. Harbour, 80l F.2d 394 (4th Cir. l986).

adversary proceeding before this Court, it is apparent that at the time R.Hadley received the GHI checks, she was fully aware that she had assigned the benefits represented by the checks to QHS. In fact, she testified that she knew the money belonged to QHS. She offered, as a defense, the fact that at the time the initial checks were received, she had not been provided with a bill from QHS, but she did acknowledge having been contacted by QHS telephonically as to the whereabouts of the GHI checks. Additionally, R.Hadley asserts that when she did receive the QHS bill in the amount of $l4,84l, she concluded that the GHI checks would be insufficient to pay QHS in full, so she opted to pay nothing to QHS. Approximately one month later, Debtors filed a voluntary Chapter 7 petition in bankruptcy. R.Hadley's explanation as to what she did with the proceeds of the GHI checks, one of which she indicates was actually received after she filed her Chapter 7 petition, was simply that she paid day-to-day bills.

While this court acknowledges the need to construe exceptions to discharge narrowly so as to protect the debtor's so-called "fresh start", such a concept cannot and will not suffice to condone R.Hadley's actions herein. The Court believes that her actions in receiving the GHI checks, causing them to be cashed and then disposing of the proceeds while being fully aware that she had assigned those very proceeds to QHS to pay for the cost of care that had been provided to her almost simultaneously, and while she was of the belief that the proceeds belonged to QHS, constitutes fraud, involving moral turpitude and/or intentional wrong.

Accordingly, the Court is of the opinion that with regard

to the embezzlement of the proceeds of the GHI checks, R.Hadley is not entitled to a "fresh start".

Based upon the foregoing, it is

ORDERED that QHS's complaint, as amended pursuant to Fed.R.Bankr.P. 70l5 and Fed.R.Civ.P. l5(b), insofar as it seeks to determine the debt due and owing from Debtors nondischargeable pursuant to Code §523(a)(2)(A) is dismissed; and it is further

ORDERED that QHS's complaint, as amended pursuant to Fed.R.Bankr. 70l5 and Fed.R.Civ.P. l5(b) insofar as it seeks to determine the debt due and owing from R.Hadley nondischargeable pursuant to Code §523(a)(4) is granted, but only to the extent of finding that the debt deemed nondischargeable is limited to the amount of the checks actually received by R.Hadley from GHI to be applied against QHS's charges, and it is finally

ORDERED that QHS's complaint as amended pursuant to Fed.R.Bankr.P. 70l5 and Fed.R.Civ.P. l5(b), insofar as it seeks to determine a debt due and owing from the Debtor Joseph Hadley to be nondischargeable pursuant to Code §523(a)(4), is denied in its entirety and dismissed.

Dated at Utica, New York
this day of May, l994

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STEPHEN D. GERLING
U.S. Bankruptcy Judge