UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

DANIEL W. KLEIN, a/k/a Officer and Shareholder in Klein Builders, Inc.
BOBBIE J. KLEIN,

Debtors

CASE NO. 90-03060

BETTY E. ELLIOTT,

Plaintiff

vs.

ADV. PRO. NO. 9l-60048A

DANIEL W. KLEIN, a/k/a Officer and Shareholder in Klein Builders, Inc. and
BOBBIE J. KLEIN,

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 by the filing of a complaint by Betty Elliott ("Plaintiff") against Daniel W. Klein, a/k/a Officer and Shareholder in Klein Builders, Inc. and Bobbie J. Klein ("Debtors"), the Defendants herein. Plaintiff's Complaint seeks a determination that the Debtors be denied a discharge in bankruptcy as to a debt owed to Plaintiff which arose out of a loan made by Plaintiff to the Debtors in November of l988 in the original sum of $l8,000.

A trial of this adversary proceeding was held on October 9, l99l at Utica, New York after which the Court reserved decision. Counsel for both parties filed post-trial memoranda of law and the matter was finally submitted

on November 5, l99l.

JURISDICTIONAL STATEMENT

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

FACTS

On October l4, l988, the Debtor, Daniel W. Klein ("D.Klein"), contacted Ronald Sirota ("Sirota"), a certified financial planner, then employed by Strategic Financial Planning, Inc., Syracuse, New York, and requested that Sirota locate a source from which D.Klein could obtain a loan in order to consolidate Debtors' short term debt. D.Klein advised Sirota that he would secure any such loan with a mortgage on his home at 7720 Ensign Circle, Liverpool, New York. D.Klein presented Sirota with a written statement of Debtors' monthly income and expenses, as well as a proposal to obtain a loan of $l5,000. (See Plaintiff's Exhibits 8 and 9).

Sirota then contacted the Plaintiff, who had been a client of Sirota's for approximately two years prior to October of l988. Sirota advised the Plaintiff that he had a potential loan transaction that would include a high rate of interest over a short term, with a balloon payment. Sirota also informed Plaintiff that the loan would be secured by equity in a house and provided Plaintiff with a profile of the Debtors.

In late October l988, and after phone calls to both the Plaintiff and D.Klein, Sirota met with Plaintiff in his office and reviewed the specifics of the loan, including the security.

Following further discussions in which D.Klein requested that Sirota obtain an increase in the amount of the loan to $20,000, and offered to provide additional security in the form of a lien on his truck, Plaintiff agreed to an increase of the loan to $l8,000 and a closing date was set for November l8, l988.

Sirota told D.Klein that it would be D.Klein's responsibility to pay

the Plaintiff's attorney's fees in connection with the preparation of the loan closing documents. D.Klein indicated that he did not wish to pay Plaintiff's attorney's fees, but that he would have his own attorney handle the transaction at a lesser fee than it would cost Plaintiff to have it done.

At the loan closing on November l8, l988, which was attended only by D.Klein, Sirota and the Plaintiff, Sirota introduced Plaintiff to D.Klein for the first time and then reviewed a promissory note which D.Klein had produced. (See Plaintiff's Exhibit 2A). Sirota subsequently filled in certain blanks in the note to include the Plaintiff's name and address, the amount of the note, the monthly payment and the date on which payments would be due. Sirota also added a provision to the note, in his handwriting, regarding fluctuations in the share price of Plaintiff's mutual fund from which she had obtained the $l8,000. Both D.Klein and Plaintiff initialled the additional provision.

Also at the closing, Sirota prepared a second note which he intended would be more binding than the note prepared by D.Klein. It contained generally the same repayment terms, but made no reference to any security and did not contain any terms regarding price fluctuation in the share price of Plaintiff's mutual fund. (See Plaintiff's Exhibit 2B).[1]

Sirota questioned D.Klein at the closing regarding the whereabouts of the remaining documents needed to effect the mortgage on his home and the lien on his truck. D.Klein told Sirota "it was going to get done". At trial, Plaintiff recalled joking with D.Klein that if he defaulted on the loan she would get his house, but did not wish to acquire his wife and children. The notes were then executed by D.Klein and Plaintiff delivered her check in the sum of $l8,000. Sirota testified that he also effected life insurance coverage on both Debtors, with the policy made payable to the Plaintiff. (See Plaintiff's Exhibit 6).[2]

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[1] The note prepared by Sirota referenced a principal amount of $l8,005, which Sirota indicated was $5.00 more than the note prepared by D.Klein to cover what he thought would be some type of filing fee.

[2] Sirota acknowledged on cross-examination that D.Klein paid him a fee of $l,375.00 for the loan transaction and he was also paid a commission on the life insurance.

On November 23, l988, Sirota wrote a letter to D.Klein referencing the "Betty Elliott loan" and reminding D.Klein that he had agreed to have his attorney prepare the mortgage documents in order to keep his costs down and that he should immediately forward the documents directly to Plaintiff. The letter also referred to "the status of the UCC-l filing for your Ford Bronco". (See Plaintiff's Exhibit 7).

Sirota later testified that he called D.Klein on at least two occasions in late November and December following the November 23rd letter inquiring as to the whereabouts of the necessary documents, and each time he was told by D.Klein that he was "working on it" or "it was getting done" or "it would be done". Sirota did not thereafter receive or become aware of D.Klein producing any closing documents, to include any second mortgage on his home.

Debtors apparently claimed a deduction on their l988 income tax return attributable to the interest paid on Plaintiff's note during that year. (See Plaintiff's Exhibit ll).

Following the closing, Debtors made their monthly payments to the Plaintiff on a timely basis for approximately two years through September of l990. At no time during that period did Plaintiff contact the Debtors and demand the production of a second mortgage on Debtors' residence and/or a lien on D.Klein's truck. In fact, Plaintiff also waived the requirement in the note that the loan be paid in full "at the end of one (l) year". (Plaintiff's Exhibit 2A).

In October 1990 Debtors defaulted in the payments on Plaintiff's note, leaving a principal balance then due Plaintiff of $l3,l66, on which interest has since accrued to the date of trial. (See Plaintiff's Exhibit 3).

On October l, l990, the Debtors sold their residence at 7720 Ensign Circle, Liverpool, New York and netted approximately $l6,000 from the sale, but no part of the sale proceeds were used to pay the Plaintiff's note. At the time of the sale of the Liverpool property, D.Klein had been out of work since June l990. On December l8, l990, Debtors filed a voluntary petition pursuant to Chapter 7 of the Bankruptcy Code (ll U.S.C. §§101-1330) ("Code") in which they listed the Plaintiff as an unsecured creditor in the sum of $13,166.00.

ARGUMENTS

Plaintiff argues that the Debtors' fraudulent intent must be inferred from their pattern of deceptive conduct. She refers to D.Klein's execution of the promissory note containing an express grant of collateral security in the form of a second mortgage on Debtors' residence and a lien on his motor vehicle. She asserts that Debtors knew that Plaintiff relied upon this form of security in making the loan to them and that in considering nondischargeability under Code §523(a)(2)(A), the reasonableness of that reliance is not a necessary element of proof.

Plaintiff contends further that D.Klein's refusal to pay for Plaintiff's attorney's fees, while representing that he would obtain counsel to prepare the necessary documentation, his sophistication regarding mortgage security gained from his experience as a residential home builder, as well as the Debtors' ultimate sale of their residence and dissipation of the net proceeds without payment to Plaintiff, all support a finding of fraudulent intent which establishes a cause of action under Code §523(a)(2)(A).

Finally, Plaintiff postures that usury is neither a defense nor a counterclaim that the Debtors may assert, since D.Klein was hardly a desperate borrower being taken unfair advantage of by an unscrupulous lender. Plaintiff also argues that Debtors actually set the interest rate and that due to D.Klein's significant experience in real estate transactions involving mortgage financing, they are estopped from asserting the usury defense.

The Debtors argue that D.Klein had only just begun his home building business when he approached Sirota in an effort to find a lender who would lend Debtors enough money to pay off their short term debt. Debtors deny that they had any prior experience with mortgages other than the one they obtained to purchase their home.

Debtors assert that they were willing to pay a l4% rate of interest and to secure the loan with a second mortgage on their home. They argue that it was the Plaintiff who insisted, through Sirota, on an l8% rate of interest and additional security in the form of a lien on D.Klein's truck.

Debtors acknowledge that while Sirota did contact D.Klein by letter

and phone shortly after the closing regarding the necessary documentation, Debtors generally made payments over approximately the next two years without Plaintiff or Sirota ever making any further demands for the mortgage and/or truck lien. Further, Debtors point out that neither party to this transaction was represented by an attorney and that no one suggested delaying the loan closing due to the lack of necessary documentation. Debtors further assert that Plaintiff waived payment in full of the loan at the end of the first year as required by the note and allowed Debtors to continue making regular monthly payments.

Finally, Debtors allege that they failed to pay off the loan from Plaintiff when they sold their residence, because D.Klein had been unemployed for several months and they didn't have any money. However, Debtors' petition and schedules indicate that they reinvested the net sale proceeds in a new house.[3]

DISCUSSION

As Plaintiff correctly observes, her burden of proof is one of a preponderance of the evidence rather than the clear and convincing standard which was generally applied to Code §523(a) actions prior to the United States Supreme Court decision in Grogan v. Garner, lll S.Ct. 654, 660 (1991).

While it is obvious that Plaintiff seeks to bar the dischargeability of the debt due her, it is not clear from the Complaint which subsection of Code §523(a) the Plaintiff actually relies on.

A review of the adversary proceeding cover sheet (B-l04) indicates that Plaintiff's cause of action relies upon Code §§523(a)(2)(4) and (6), while Plaintiff's oral arguments and proof at trial, as well as her Memorandum of Law, limits the statutory basis of her action to Code §523(a)(2)(A). Thus, the Court views Plaintiff's Complaint as one based only upon that provision of the Code.

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[3] At the conclusion of trial both parties stipulated that the Court could take judicial notice of the Petition and Schedules filed by Debtors. See Statement of Affairs, Item 12.

In order to establish a basis for nondischargeability of a debt pursuant to Code §523(a)(2)(A), the Plaintiff must establish: (l) that Debtor made a representation to her; (2) that the representation was knowingly false or was made with reckless disregard for its truth; (3) that Debtor made such false representation with an intent and purpose to deceive Plaintiff; (4) that the Plaintiff reasonably relied on the representation and (5) the Plaintiff sustained a loss as a result of the representation having been made. See Calgagno v. Ezell, ll2 B.R. l46 (E.D.La. l990); In re Nahas, 92 B.R. 726 (E.D.Mich. l988); In re Tesmetges, 86 B.R. 2l (E.D.N.Y. l988); In re Shaheen, lll B.R. 48 (S.D.N.Y. l990); In re Gans, 75 B.R. 474 (Bankr. S.D.N.Y. l987); In re Wood, 75 B.R. 308 (Bankr. N.D.N.Y. 1987).

The Plaintiff is required to establish actual fraud rather than implied fraud. See In re Smith, 98 B.R. 423 (Bankr. C.D.Ill. l989); In re Scoggins, 52 B.R. 86 (Bankr. N.D.Ala. l985); In re Haas, 29 B.R. 566 (Bankr. M.D.Fla. l983); In re Barrup, 37 B.R. 697 (Bankr. D.Vt. l983); In re Woodhull, 30 B.R. 83 (Bankr. E.D.Ark. 1983).

There also must be a showing by the Plaintiff that the Debtors' representations amount to more than simply the failure to fulfill a promise. See In re DiMarco, l05 B.R. l28 (Bankr. S.D.Fla. l989); In re Guy , l0l B.R. 96l (Bankr. N.D.Ind. l988); In re Gans, supra, 75 B.R. at 474; In re Faulk, 69 B.R. 743 (Bankr. N.D.Ind. l986); In re Collins, 28 B.R. 244 (Bankr. W.D.Okla. l983); In re Overmyer, 30 B.R. l27 (Bankr. S.D.N.Y. l983). However, where an actual intent to deceive is not established, a showing by Plaintiff of a reckless disregard for the truth may suffice. See In re Richey, l03 B.R. 25 (Bankr. D.Conn. l989); In re Archer, 55 B.R., l74 (Bankr. M.D.Ga. l985); In re Lange, 40 B.R. 554 (S.D.Ohio l984).

At the outset, the Court observes there is no showing that the Debtor, Bobbie J. Klein, in any way participated in the transaction which resulted in the loan to her husband. Plaintiff's witness Sirota testified that he had one conversation with Mrs. Klein in which she referred to him as a "life saver" in obtaining the loan requested by her husband. Beyond that, there is no proof that she was in any way involved and the Complaint as to the Debtor, Bobbie J. Klein, is dismissed.

Considering the proof as it relates to D.Klein, the Court must conclude that even given a lesser burden of proof, namely the preponderance standard established in Grogan, supra, Plaintiff has failed to establish a cause of action for nondischargeability pursuant to Code §523(a)(2)(A). See In re Branham, 126 B.R. 283, 287 (Bankr. S.D.Ohio 1991).

The proof does clearly establish that the Plaintiff was not an individual with any degree of business acumen and was relying primarily on the expertise of Sirota, her agent, rather than any representations of D.Klein to protect her right to be repaid the amount of her loan. Further, in spite of Plaintiff's efforts to portray D.Klein as an astute businessman having extensive experience with mortgages, the proof indicates that, at the time of the loan from Plaintiff, other than a singular mortgage transaction in connection with the purchase of his home, he was a neophyte in this regard.

For D.Klein's part, the record does not disclose any fraudulent intent or for that matter, any reckless disregard for the truth. The record indicates that D.Klein intended, prior to the note closing, to provide both the second mortgage and the vehicle lien, and there is no proof that it would have been impossible for him to have provided both to the Plaintiff. See In re Tesmetges, supra, 86 B.R. at 23; In re Nahas, supra, 92 B.R. at 730; In re Guy, supra, 101 B.R. at 977-978; In re Wood, supra, 75 B.R. at 313; In re Woodhull, supra, 30 B.R. at 86.

What does appear to have occurred is that D.Klein sought to avoid incurring the attorney's fees (his or Plaintiff's) that would have been generated by the preparation of a note, mortgage and security agreement, prior to the loan closing. Therefore, he went to the closing with his "homemade" note, hoping to obtain the loan from the Plaintiff without the necessity of producing the remaining security documents at that time. When questioned as to the lack of the necessary paperwork, he simply responded that "it was going to get done".

Ironically, Sirota, apparently sensing the need to protect the interests of the Plaintiff, modified the note presented by D.Klein to reflect fluctuations in the "share price of her mutual fund". Additionally, Sirota effected a life insurance policy on the Debtors' lives payable to Plaintiff, drafted a second note which he felt would be more binding on D.Klein and provided

Plaintiff with an amortization schedule for the loan. (See Plaintiff's Exhibits 2A, 2B, 3 and 6).

Sirota did not, however, suggest to the Plaintiff that she withhold making the loan to D.Klein until he provided the necessary documentation to simultaneously create a second mortgage on his home and a lien on his motor vehicle. Plaintiff, on the assumption that D.Klein's statements must be deemed fraudulent, urges this Court to adopt the position of the Eighth Circuit Court of Appeals in In re Ophaug, 827 F.2d 340, 343 (8th Cir. l987) that a creditor need not show that its reliance on the misrepresentations of the debtor was reasonable in order to succeed under Code §523(a)(2)(A). It appears that if this Court were to abandon the position it previously adopted in In re Gould, 73 B.R. 225, 227 (Bankr. N.D.N.Y. l987) and follow Ophaug, supra, Plaintiff's reliance on D.Klein's statement that "it was going to get done" might be sufficient to deny dischargeability, assuming the other necessary factors were present.

The Eighth Circuit acknowledges a split of authority on the reasonableness of the reliance, but In Ophaug concluded that since Congress utilized the terms "reasonably relied" in Code §523(a)(2)(B), but not in (a)(2)(A), it intended that a court need find only reliance under (a)(2)(A). Other Circuits, as well as lower courts, however, have not embraced the conclusion reached in Ophaug, supra. See In re Rubin, 875 F.2d 755, 759 (9th Cir. 1989); In re Mullet, 8l7 F.2d 677, 679 (10th Cir. 1987); In re Kimzey, 76l F.2d 42l, 423 (llth Cir. l985); In re Shaheen, supra, lll B.R. at 53; In re Howarter, ll4 B.R. 682, 685 (9th Cir. BAP 1990); In re O'Brien, ll0 B.R. 27, 32 (Bankr., D.Colo. 1990); In re Yates, ll8 B.R. 427, 432 (Bankr. D.S.C. l990).

As indicated, however, the Court need not reach the question of reliance where there is no showing of a false representation or a reckless disregard for the truth. The proof shows an intent by D.Klein to provide the necessary documents, if not at the closing, then in the future, perhaps at a point in time when he could afford the legal fees. However, a promise to perform an act in the future does not render the resulting debt nondischargeable simply because the Debtor abandons his or her promise. See COLLIER ON BANKRUPTCY (llth Ed. l989) ¶523.08[4]; In re DiMarco, supra, l05 B.R. at l3l; In re Guy, supra,

l0l B.R. at 979; In re Gans, supra, 75 B.R. at 475; In re Faulk, supra, 69 B.R. at 750.

It is insufficient to contend that because of the Plaintiff's naiveté in matters of mortgages and security interests, she was easily duped by D.Klein. Further, it is apparent that Sirota, a certified financial planner, conceded to be her agent in the transaction, had sufficient business acumen to realize that the making of a loan and the execution of a mortgage and security agreement intended as collateral for the loan need be executed simultaneously.

Certainly, the events that occurred after November of l988 attest to the mood of all of the parties that the mortgage and security agreement, if once intended as an essential component of the loan transaction, were soon forgotten, at least until approximately two years later when the Debtors resorted to bankruptcy in December of 1990. See In re Stone, 43 B.R. 377, 380 (Bankr. D.Vt. 1984).

Plaintiff has failed to establish that D.Klein made either a false representation or a statement evidencing a reckless disregard for its truth. See In re Yates, supra, 118 B.R. 427, 432; In re Black, 113 B.R. 79, 82 (Banker. M.D. Fla. 1990); In re Stone, supra, 43 B.R. at 379-80. Thus, the Court need not consider any of the remaining factors which would render the debt nondischargeable in accordance with Code §523(a)(2)(A), nor will it discuss the Debtors' affirmative defense of usury under state law.

Debtors have, however, asserted a counterclaim based upon usury and seek to recover the interest paid by Debtor on the note in excess of the alleged legal rate.

28 U.S.C. §§157(b)(2)(A) through (O) purport to define those matters over which a bankruptcy court has "core" jurisdiction. Section l57(b)(2)(C) refers to "counterclaims by the estate against persons filing claims against the estate". It has been held that if the counterclaim is compulsory in nature, that is if it arises from the same event or occurrence which gives rise to the creditor's claim, then §157(b)(2)(C) provides a basis of core jurisdiction. See In re Yagow, 53 B.R. 737, 740 (Bankr. D.N.D. l985).

Here, however, there is no claim being made against the estate and there is no claim being asserted by the estate. The claim of nondischargeability

is made against the Debtors, not their bankruptcy estate, and they seek personally to assert a claim for recovery of usurious interest against the Plaintiff.

The Court believes that pursuant to Code §54l, the claim for alleged usurious interest belongs not to the Debtors, but to their bankruptcy estate, and may be asserted by its Trustee either directly against the Plaintiff or by way of a compulsory counterclaim in the event the Plaintiff has filed a claim against the estate. See McCollum v. Hamilton Nat'l Bank, 303 U.S. 245, 82 L.Ed. 8l9, 535 S.Ct. 568 (l938); Lambert v. Fuller, l22 B.R. 243, 245 (E.D.Pa. l990); In re Bell & Beckwith, 64 B.R. l44 (Bankr. N.D.Ohio l986); In re Couch, 43 B.R. 56, 59 (Bankr. E.D.Ark. l984).

Thus, the Court will likewise dismiss the Debtors' counterclaim without reaching the merits.

Based on the foregoing, it is

ORDERED that this adversary proceeding, to include Debtors' counterclaim, be and it is hereby dismissed, without costs to either party.

Dated at Utica, New York
this day of February, l992

STEPHEN D. GERLING
U.S. Bankruptcy Judge