UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF IOWA

IN RE:	
	Chapter 7
PATRICK WADE and CERINA WADE,	Bankruptcy No. 03-01568
Debtors.	
BRANDON T. STONE and JACKIE D. STONE,	
	Adversary No. 03-09163
Plaintiffs,	
vs.	
PATRICK WADE and CERINA WADE,	
Defendants.	

ORDER RE COMPLAINT TO DETERMINE DISCHARGEABILITY OF DEBT

This matter came before the undersigned for trial on November 9, 2004. Plaintiffs Brandon T. Stone and Jackie D. Stone were represented by Attorney Renee Hanrahan. Debtors Patrick Wade and Cerina Wade were represented by Attorney Thomas Fiegen. After the presentation of evidence and argument, the Court took the matter under advisement. The time for filing briefs has now passed and this matter is ready for resolution. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(I).

STATEMENT OF THE CASE

Plaintiffs Brandon and Jackie Stone filed a complaint seeking exception to discharge under § 523(a)(2), § 523(a)(4), and § 523 (a)(6). They assert damages resulting from Debtors' construction work on their home are excepted from discharge for fraud, defalcation in a fiduciary relationship and willful injury. Debtors deny they made any misrepresentations or intended to defraud or injure the Stones.

FINDINGS OF FACT

Debtors' businesses have a complex network of ownership. Wade Companies is a sole proprietorship that owns the business interests of Mr. Wade. Altered Earth Excavating Equipment, Inc. is an Iowa corporation of which Mr. Wade is the president and Mrs. Wade is the secretary and treasurer. ICF Structural, L.L.P. is a partnership between Mr. Wade and Daniel J. Dolezal, with Mrs. Wade being allowed to perform check authorization and account transfers with Solon State Bank. Mr. Wade is an employee/owner of Altered Earth and took ownership draws from Wade Companies and from ICF Structural when there was a profit.

Mr. Wade had financial control of Wade Companies, Altered Earth, and ICF Structural. Mrs. Wade performed minor bookkeeping tasks, such as collection of time sheets from contractors or delivery of documents to the construction sites. Dan Dolezal managed the daily on-site construction work for ICF Structural and most of the supply orders, while Mr. Wade managed the finances. Mr. Dolezal oversaw the daily work on the Stones' home. Gordy Burdick, Todd Biles, Kevin Eely, and Scott Eely were independent sub-contractors who all worked on Mr. Wade's companies' projects.

The Oxford, Iowa land development led Debtors to create a commercial relationship with Solon State Bank. Solon State Bank lent the money and controlled the release of funds to pay invoices for the development project. Solon State Bank was Debtors' main lender.

In January 2001, the Stones met with Debtors in Debtors' home to discuss the purchase of a lot in the development. After discussing availability of lots, they discussed the possibility of Debtors' company building the Stones an insulated concrete form home. Debtors showed the Stones Debtors' home, which Mr. Wade had built using the insulated concrete form process. Debtors informed the Stones of other insulated concrete form buildings that Mr. Wade built.

On March 14, 2001, the Stones and Debtors entered into a residential real estate purchase agreement for the construction of a home. The agreement was made by and between

Mr. Wade and Brandon Stone pending construction financing. The sale price of the home and land was $131,900. The contract terms required a $500 deposit into Debtors' trust account and completion of the house by July 1, 2001.

Debtors could not secure financing for the building of the home, so the Stones had to obtain their own financing. Solon State Bank refused to extend credit to Debtors for the home construction. In a new agreement made on June 12, 2001, the Stones would purchase the land separately and Wade Companies would be the contractor who would build the house. The price of the home construction was $109,000 to be paid through monthly construction draws from invoices provided by Debtors. Debtors agreed to pay the interest on the loan during the construction period. The home was to be completed 120 working days after work was begun, but no later than November 15, 2001. The agreement was signed by both Debtors, Brandon Stone and Jackie Stone.

Construction began under the first contract in April 2001, but stopped in May 2001 due to the lack of financing. While the second contract was entered into in June 2001, a delay in financing prevented construction from continuing until August 2001. In early February 2002, the Stones fired Wade Companies. In early April 2002, James Kempf took over the construction of the home.

Soon after firing Wade Companies, the Stones had the home inspected by Randy Van Winkle, an engineer who specializes in forensic engineering. He found some problems with the house. There were minor drywall problems. There was a gap in the roof which would require the addition of a specialized drainage device. There was an exposed wall that needed siding. The kitchen floor needed the additional support of an I-beam before heavy appliances were installed. Finally, some steel studs needed to be replaced or possibly reinstalled. Mr. Van Winkle stated that all the repairs could be easily fixed. All of the problems noted were capable of being rectified without a loss of structural integrity. At the time it was fired, Wade Companies had spent $54,736.26 in materials and $34,868.75 in labor.

The Stones have three claims. First, they assert Debtors violated § 523(a)(2) based on misrepresentations and actual fraud. The Stones accuse Debtors of misrepresenting (i) their expertise in construction, (ii) their ability to handle funds for the payment of subcontractors and suppliers, (iii) that the work would be performed within a specific time period and in a workmanlike manner, and (iv) that they would pay the interest on the construction loan. Second, the Stones allege Debtors violated § 523(a)(4) by mismanaging the loan proceeds. They charge that Debtors used the loan proceeds to pay or barter with suppliers in projects other than the Stones' home construction project. The Stones claim Debtors breached their fiduciary duty in their role as contractors. Third, the Stones assert Debtors violated § 523(a)(6) by intentionally targeting the Stones with a conversion of funds and materials.

CONCLUSIONS OF LAW

Plaintiffs must prove the elements of their claims under § 523(a) by a preponderance of evidence. Grogan v. Garner, 498 U.S. 279, 285 (1991). Exceptions to discharge must be "narrowly construed against the creditor and liberally against the debtor, thus effectuating the fresh start policy of the Code. These considerations, however, 'are applicable only to honest debtors.'" In re Van Horne, 823 F.2d 1285, 1287 (8th Cir. 1987).

§ 523(a)(2)(A)

Section provides 523(a)(2)(A) in pertinent part:

> (a) A discharge under section 727 . . . does not discharge an individual debtor from any debt
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> . . .
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by--
>
> (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition.

11 U.S.C. § 523(a)(2)(A).

In the Eighth Circuit, a creditor proceeding under §523(a)(2)(A) must prove the following elements: (1) the debtor made representations; (2) at the time made, the debtor knew them to be false; (3) the representations were made with the intention and purpose of deceiving the creditor; (4) the creditor justifiably relied on the representations; and, (5) the creditor sustained the alleged injury as a proximate result of the representations having been made. In re Ophaug, 827 F.2d 340, 342 n.1 (8th Cir. 1987), as modified by Field v. Mans, 516 U.S. 59, 74-75 (1995) (holding that "§ 523(a)(2)(A) requires justifiable, but not reasonable, reliance").

§ 523(a)(4)

The Bankruptcy Code provides that an individual debtor in a Chapter 7 case is not discharged from any debt "for fraud or defalcation while acting in a fiduciary capacity...." 11 U.S.C. § 523(a)(4). To prevent the discharge of debt under §523(a)(4), it is incumbent upon the plaintiff to establish the following two elements: (1) that a fiduciary relationship existed between the debtor and the plaintiff; and (2) that the debtor committed fraud or defalcation in the course of that fiduciary relationship. See In re Montgomery, 236 B.R. 914, 922 (Bankr. D.N.D. 1999).

With regard to the first element, whether a relationship is a fiduciary relationship within the meaning of § 523(a)(4) is a question of federal law. In re Cochrane, 124 F.3d 978, 984 (8th Cir. 1997). The fiduciary relationship must be one arising from an express or technical trust. In re Long, 774 F.2d 875, 878 (8th Cir. 1985). A mere contractual relationship is less than what is required to establish the existence of a fiduciary relationship. Werner v. Hofmann, 5 F.3d 1170, 1172 (8th Cir. 1993).

Bankruptcy courts regularly look to state law to determine whether a fiduciary capacity exists. In re Long, 774 F.2d 875, 878 (8th Cir. 1985); In re Kondora, 194 B.R. 202, 208 (Bankr. N.D. Iowa 1996). Under Iowa law, a trust has been defined as "a fiduciary relation with respect to property, subjecting the person by whom the property is held to equitable duties to deal with the property for the benefit of another person, which arises as the result of a manifestation of intention to create it." State v. Caslavka, 531 N.W.2d 102, 105 (Iowa 1995). One indicia of a trust relationship is the requirement of a separate bank account for the receipt and holding of trust funds. In re Pehkonen, 15 B.R. 577, 581 (Bankr. N.D. Iowa 1981). “Cash advanced as a down payment will not qualify as 'property of another' because title and possession are transferred from the owner to the contractor--not in trust--but outright." State v. Galbreath, 525 N.W.2d 424, 427 (Iowa 1994) 427.

§ 523(a)(6)

Section 523(a)(6) provides that debts for "willful and malicious injury by the debtor to another entity" can be excepted from discharge. 11 U.S.C. § 523(a)(6).

> Under section 523(a)(6), a debtor is not discharged from any debt for "willful and malicious injury" to another. For purposes of this section, the term willful means deliberate or intentional. See Kawaauhau v. Geiger, 523 U.S. 57, 61 (1998) (§ 523(a)(6) requires deliberate or intentional injury); In re Long, 774 F.2d 875, 881 (8th Cir.1985) (to meet willfulness component of § 523(a)(6), debtor's actions creating liability must have been “headstrong and knowing”). To qualify as “malicious,” the debtor's actions must be “targeted at the creditor ... at least in the sense that the conduct is certain or almost certain to cause financial harm.” Long, 774 F.2d at 881.

In re Madsen, 195 F.3d 988, 989 (8th Cir. 1999). A willful and malicious conversion is an “injury” under § 523(a)(6). In re Ziadeh, 284 B.R. 893, 900 (Bankr. N.D. Iowa 2002).

ANALYSIS

Plaintiffs first seek to except their claim from discharge under § 523(a)(2)(A). They accuse Debtors of misrepresenting: 1) their expertise in construction, 2) their ability to handle funds for the payment of subcontractors and suppliers, 3) that work would be performed within a specific time period and in a workmanlike manner, and 4) that they would pay the interest on construction loans. The first element of § 523(a)(2)(A) requires that Debtors make representations. Very little evidence was presented as to the specific comments made by either Debtor. However, based upon the record presented, it appears clear that, in their attempt to sell their process of homebuilding, Debtors individually or collectively made representations about the quality of this type of construction and their ability to construct this house.

The fourth element requires that Plaintiffs justifiably relied on any representations which were made. The record establishes that Plaintiffs relied upon Debtors and anticipated that the house would be completed according to the terms of the contract and the representations which were made by Debtors. However, the critical elements under any claim of fraudulent misrepresentation are that the debtor knew the representations to be false when made and that they were made with the intention and purpose of deceiving another party. Debtors testified that any representations which were provided to Plaintiffs were made with the intention of completely fulfilling their promises.

There is substantial testimony in the record that the course of the project did not go as smoothly as Plaintiffs or Debtors would have preferred. Financing and other problems caused the construction to be started and then stopped on several occasions. Additionally, there were portions of the construction which were performed unsatisfactorily. However, there is little, if any, evidence to establish that Debtors made representations which they believed to be untrue. In fact, the evidence supports a contrary conclusion. Debtors were deeply committed to completing an entire development. Plaintiffs were the first individuals to buy a parcel of ground in this new development. In order to sell additional lots and build additional homes, it was necessary that Debtors establish a positive relationship with their first customers. With that goal in mind, Debtors would have no interest in making inaccurate representations to Plaintiffs or deceiving them, and running the risk of a dissatisfied customer in the first home in the development.

While the construction of the house progressed slowly, and though the house had evident deficiencies, the construction engineer hired by Plaintiffs recognized that there were no problems which could not readily be corrected. Plaintiffs’ engineer concluded that any necessary repairs were of a relatively minor nature.

As to Plaintiffs’ first theory of fraudulent misrepresentation, the Court concludes that there is no showing that Debtors made unrealistic representations at the time of the initial contract. It is the conclusion of this Court that, at the time the representations were made, Debtors had every reason to correctly represent their capabilities and little, if any, reason to deceive Plaintiffs. The amount of materials and labor which went into the home, up to the point when Debtors were terminated, reasonably represents the state of the home at that time. This Court concludes that any representations which were made were truthfully made by Debtors with the intention of carrying out those representations. It is further the conclusion of this Court that Debtors did not, at any time, intend to deceive Plaintiffs. Therefore, the claim under § 523(a)(2)(A) must be denied.

Secondly, Plaintiffs allege that their claim should be excepted from discharge pursuant to § 523(a)(4), asserting Debtors acted in a fiduciary capacity. The existence of a fiduciary relationship is an issue of state law. The fiduciary relationship must arise from an express or technical trust and not from a mere contractual relationship.

An examination of the record in this case establishes that Plaintiffs have proven nothing more than an ordinary contractual relationship for the construction of a house. Iowa law strictly construes what is and what is not a fiduciary relationship. Under Iowa law, a trust cannot be created unless there is a specific manifestation of an intention to create a trust. This record is devoid of any showing of intent of these parties to create a trust. The parties created a garden variety home construction contract. As there was no trust relationship created, § 523(a)(4) is not applicable to this case. Plaintiffs’ claim of nondischargeability against Debtors under § 523(a)(4) must be denied.

Finally, Plaintiffs assert that this obligation is excepted from discharge under § 523(a)(6). This section provides that debts for willful and malicious injury by the debtor to another entity are excepted from discharge. To be nondischargeable under this section, Plaintiffs must establish a deliberate or intentional injury. In addition, Plaintiffs must establish that Debtors conduct was malicious. Malicious, as used in this section, means that Debtors’ conduct was specifically targeted at Plaintiffs with the knowledge that financial harm was certain or almost certain to follow.

While the course of this project did not go smoothly, there is no evidence in this record to show that Debtors intentionally or deliberately intended to harm Plaintiffs. There is a complete lack of evidentiary support for the notion that Debtors targeted Plaintiffs for the purpose of causing them financial harm. As such, Plaintiffs have failed to establish the requisite elements for relief under § 523(a)(6).

In summary, this Court concludes that this was a project started by Debtors and Plaintiffs with positive intentions. For a multitude of reasons, the project became derailed and did not live up to anyone's expectations. Nevertheless, problems and delays do not equal fraud or malicious intent. Plaintiffs' claims herein are not based on whether Debtors completed their contract in a workmanlike manner. They are based on principles of fraud and willfulness. There is no evidentiary support for a conclusion under any theory that Debtors desired to have this project go bad any more than Plaintiffs. It is the ultimate conclusion of this Court that Plaintiffs have failed to establish, by a preponderance of evidence, any theory under which their claims of exception from discharge should be granted.

WHEREFORE, Plaintiffs' Complaint to Determine Dischargeability of Debt is DENIED.

FURTHER, Plaintiffs' claim is not excepted from discharge under § 523(a)(2)(A), § 523(a)(4) or § 523(a)(6) for the reasons set out herein.

Dated and Entered: December 29, 2004

Paul J Kilburg

PAUL J. KILBURG
CHIEF BANKRUPTCY JUDGE