In the United States Bankruptcy Court

for the Northern District of Iowa

Western Division

NETWORK COMMUNICATIONS INC. *Debtor(s).*	Bankruptcy No. X90-02242S Chapter 11
NETWORK COMMUNICATIONS INC. *Plaintiff(s)* vs. U. S. SPRINT COMMUNICATIONS CO. A Limited Partnership *Defendant(s)*	Adversary No. X91-00085S

ORDER RE: U. S. SPRINT'S MOTION FOR SUMMARY JUDGMENT

In this proceeding, Network Communications, Inc. (NCI), the debtor-in-possession, seeks to recover from U. S. Sprint Communications Co. (SPRINT) an amount of money allegedly due and owing for services performed within 90 days of the bankruptcy. Sprint has moved for summary judgment. Hearing on the motion was held on October 29, 1991 in Sioux City. This is a core proceeding under 28 U.S.C. § 157(b) (2) (E) .

I.

In August, 1990, NCI and Sprint entered into a contract under which NCI would market, by telephone, Sprint's residential long distance telephone services. The contract prescribed sales goals and commission fees for accomplished sales. The contract provided that Sprint, at its discretion, could pay NCI in advance a percentage of each month's sales goal during the first four months. If it did so, Sprint would credit such advance payment against the invoice submitted by NCI for actual sales. It was also agreed that NCI would use and pay for Sprint's long distance telephone service in its sales operation, but that Sprint would reimburse NCI for a portion of the cost on a per sale basis. The agreement was for a twelve-month period, but contained various termination options.

Sprint advanced NCI substantial amounts of money for September, October, and November 1990 sales goals and for advance reimbursements of telephone costs. During these early months of the contract's performance, NCI fell steadily and substantially behind in reaching sales goals. Sprint was advancing NCI larger sums than NCI was able to earn. At NCI's request, representatives of Sprint and NCI began discussions to modify the agreement. The contract provided that any modifications to the contract must be in writing.

NCI submits that the parties reached an oral agreement to amend on December 3, 1990. Sprint denies that any final agreement was reached and contends that NCI officer Mark Ferdig had been informed during the negotiations that any agreement was subject to approval by Sprint senior management. NCI's attempt to obtain a written modification to the contract failed, and the company shut down. It filed its chapter 11 petition on December 24, 1990. By that time, NCI had earned approximately $90,000.00 for December sales. Its pre-petition debt to Sprint was substan-tially more. After the filing of the petition, Sprint notified NCI that it had exercised its right of recoupment and deducted the December commission obligation from the money which was owed to it.

NCI brought this proceeding against Sprint to recover the December sales commissions. Sprint asserts that it was within its right to recoup. NCI, however, argues that recoupment is an equitable doctrine and that Sprint should not be able to recoup because it acted inequitably toward NCI. The inequitable conduct is alleged to have been Sprint's misrepresentation to NCI that it would modify the contract. Absent such promise to modify, NCI claims it would have ceased operations at the end of November, 1990, and as a result, the December sales would never have been made. NCI alleges that Sprint strung it along during all or a part of the negotiation period and that such conduct should not serve to improve Sprint's position at the expense of company investors and employees whose financial investment or labors created the December sales.

II.

This case involves the application of the doctrine of recoupment, the federal rules governing summary judgments and the Iowa law of fraudulent misrepresentation.

A. RECOUPMENT

The common law doctrine of recoupment is distinguishable from the Bankruptcy Code's provision for setoff. Setoff is authorized by 11 U.S.C. § 553, and it allows a creditor to setoff a pre-petition mutual debt owed by a debtor against debts which he or she may owe to that debtor. As counsel for Sprint notes in his brief, setoff is subject to certain restrictions. A trustee may be able to recover a debt offset by a creditor if the setoff occurs on or within 90 days of the filing of the bankruptcy petition, and setoff under § 553 without the court's approval may be a violation of the automatic stay. 11 U.S.C. § § 362 and 553. The mutual debts exchanged under setoff most often stem from different transactions. "For recoupment to apply, however, the creditor must have a claim against the debtor that arises from the same transaction as the debtor's claim against the creditor." Bird v. Carl's Grocery Co. (In re NWFX), 864 F.2d 593, 597 (8th Cir. 1989). Recoupment does not create a voidable preference, and it is not a violation of the automatic stay. *See* Visiting Nurse Ass'n. of Tampa Bay, Inc. v. Sullivan (Matter of Visiting Nurse Ass'n. of Tampa Bay, Inc.), 121 B.R. 114, 120-21 (Bankr. M.D. Fla. 1990) ("[a]ll the courts reviewing recoupment within the concept of preference have looked to Section 553 and to Collier on Bankruptcy and have determined there is no preference."); Rooster, Inc. v. Raphael Roy, S.R.L. (In re Rooster, Inc.), 127 B.R. 560, 570 (Bankr. E.D. Pa. 1991) ("While the automatic stay, 11 U.S.C. § 362(a) (7), forbids a creditor from using setoff rights under section 553, [citation omitted], it does not prevent it from using its right of recoupment.")

Generally, recoupment occurs when "a creditor has paid or advanced to the debtor more funds pre-petition than have been earned by the debtor as of the date of filing." Matter of American Sunlake Ltd. Partnership, 109 B.R. 727, 731 (Bankr. W.D. Mich. 1989). *Accord* Brown v. Snellen (In re Giesing), 96 B.R. 229, 232 (Bankr. W.D. Mo. 1989). As in the present case, many cases of recoupment involve a "single contract" which provides "for advance payments based on estimates of what ultimately would be owed, subject to later correction." Ashland Petroleum Co. v. Appel (In re B & L Oil Co.),

782 F.2d 155, 157 (10th cir. 1986). *See also*American Central Airlines, Inc. v. Dept. of Transportation (In re American Central Airlines, Inc.), 60 B.R. 587, 591 (Bankr. N.D. Iowa 1986). The doctrine of recoupment has been endorsed by the Eighth Circuit. Bird v. Carl's Grocery Co. (In re NWFX), 864 F.2d 593 (8th Cir. 1989).

Both sides in the instant case have recognized the applicability of recoupment to the present situation. Network's contention, however, is that sprint's alleged inequitable conduct prevents it from invoking the equitable doctrine. Network's position finds support in case law. In American Sunlake, the court rejected an attempt by the creditor to use recoupment against the debtor because of the creditor's inequitable conduct. Citing the maxim, "he who comes into equity must come with clean hands," the court held that the creditor "cannot use the judgment owed to the Debtor resulting from its own misdeeds to seek to utilize the equitable doctrine of recoupment." American Sunlake, 109 B.R. at 731. The court continued:

> 'This maxim is far more than a mere banality. It is a self-imposed ordinance that closes the doors of a court of equity to one tainted with inequitableness or bad faith relative to the matter in which he seeks relief, however improper may have been the behavior of the defendant.' Precision Instrument Manufacturing Co. v. Automotive Maintenance Machinery Co., 324 U.S. 806, 814, 65 S.Ct. 993, 997, 89 L.Ed. 1381 (1945). To allow [the creditor] to recoup the judgment owed to the Debtor against the amount it has paid [to the mortgagee] would be to unjustly and inequitably reward [the creditor] to the detriment of the Debtor's ability to reorganize in this case.

American Sunlake, 109 B.R. at 731. *See also*, In re Drexel Burnham Lambert Group, Inc., 113 B.R. 830 (Bankr. S.D.N.Y. 1990) .

The principle found in American Sunlake may be applicable in this case. If NCI can prove that Sprint has acted inequitably and that the inequitable conduct created the debt owed to NCI, then Sprint's actions may bar its use of recoupment.

B. SUMMARY JUDGMENT

In the past, federal courts have expressed reluctance to grant motions for summary judgment. Approximately five years ago, the Supreme Court enunciated new standards in ruling on motions for summary judgment. The court's decisions in a trilogy of cases liberalized the criteria under which federal courts will consider such motions. Celotex Corp. v. Catrett, 477 U.S. 317, 106 S.Ct. 2548, 91 L.Ed.2d 285 (1986); Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986); and Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986). "[A]ny hesitation about granting summary judgment motions is no longer appropriate in light of the Supreme Court's decisions" in these three cases. Midwest Radio Co., Inc. v. Forum Pub. Co., 942 F.2d 1294, 1296 (8th Cir. 1991). Although the Eighth Circuit views summary judgment as "a drastic remedy" which "must be exercised with extreme care", the Court of Appeals has also recognized the principle that "'summary judgment procedure is properly regarded not as a disfavored procedural shortcut, but rather as an integral part of the federal rules as a whole, which are designed to secure 'the just, speedy and inexpensive determination of every action.''" Wabun-Inini v. Sessions, 900 F.2d 1234, 1238 (8th Cir. 1990), *quoting* Celotex Corp., 477 U.S. at 327; 106 S.Ct. at 2554-55 (*quoting* in turn, Fed. R.Civ. P. 1).

Summary judgment is appropriate when the moving party demonstrates that there is "no genuine issue of material fact", Anderson, 477 U.S. at 248, 106 S.Ct. at 2510, and it is entitled to judgment in its favor as a matter of law. Fed. R.Civ. P. 56(c).

A defendant seeking summary judgment "has the burden of showing that there is no genuine issue of [material] fact." Anderson, 477 U.S. at 256, 106 S.Ct. at 2514. A defendant typically meets its burden in one of two ways: "[T]he defendant may affirmatively offer evidence which undermines one or more of the essential elements of the plaintiff's case; or, the defendant may simply demonstrate that the evidence in the record falls short of establishing an essential element of the plaintiff's case." International Shortstop, Inc. v. Rally's, Inc., 939 F.2d 1257, 1264 (5th Cir. 1991).

If the moving party's assertions bear out the claim that no genuine issue of material fact exists, the burden then shifts to the non-moving party "to set forth affirmative evidence, specific facts, showing that there is a genuine dispute on [a material] issue." City of Mt. Pleasant, Iowa v.Assoc. Elec. Co-op, 838 F.2d 268, 274, *citing* Anderson, 477 U.S. at 257, 106 S.Ct. at 2514. "[T]he plain language of Rule 56(c) mandates the entry of summary judgment . . . against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial." Celotex Corp., 477 U.S. at 322, 106 S.Ct. at 2552-53. *See* Pourmehdi v. Northwest Nat. Bank, 849 F.2d 1145, 1146 (8th Cir. 1988).

C. THE IOWA LAW OF FRAUDULENT MISREPRESENTATION

NCI claims that sprint should be denied the right to use the equitable doctrine of recoupment because Sprint's own conduct in obtaining the December sales was inequitable. NCI alleges that Sprint's representatives bargained with NCI in bad faith over an amendment to the NCI-Sprint contract without any real intention of executing an amendment to the contract in an effort to induce NCI to continue operating at its own expense generating additional sales for Sprint.

Although NCI has couched its defense to recoupment in terms of inequitable conduct, it states at least twice in its brief that Sprint's actions constituted a misrepresentation. Seven elements are necessary to prove fraudulent misrepresentation, and they include: (1) a representation; (2) falsity; (3) materiality; (4) scienter (a knowledge that the representation in question is false); (5) an intent to deceive; (6) reliance; and (7) resulting injury and damage to the plaintiff. B & B Asphalt Co. v. T. S. McShane Co., 242 N.W.2d 279, 284 (Iowa 1976); Cornell v.Wunschel, 408 N.W.2d 369, 374 (Iowa 1987). A plaintiff alleging such an action must overcome the presumption of fair dealing by individuals in the conduct of their business activities. Hall v.Wright, 261 Iowa 758, 156 N.W.2d 661, 666 (1968); Wyckoff v. A & J Home Benevolent Assoc.of Creston, Iowa, 254 Iowa 653, 119 N.W.2d 126, 129 (1962). In order to overcome this presumption, the Iowa court has set a high standard of proof--the plaintiff must establish its claim by a preponderance of clear and convincing evidence.[(1)] This standard of proof is distinguished "qualitatively, rather than quantitatively" from a mere preponderance. Omaha Bank, for Cooperatives v. Siouxland Cattle Co-op, 305 N.W.2d 458, 464 (Iowa 1981) (*quoting* Mills County State Bank v. Fisher, 282 N.W.2d 712, 716 (Iowa 1979)). Plaintiff in the instant case must furnish proof of fraud from which a clear inference of fraud may be drawn.

The nature of fraudulent misrepresentation makes direct proof of fraud difficult. The elements of fraud must often be proven by circumstantial evidence. Kunkle Water & Elec. v. City of Prescott, 347 N.W.2d 648 (Iowa 1984); Northrup v. Miles Homes, Inc., 204 N.W.2d 850, 859 (Iowa 1973).

> Fraud is not committed openly. It is an offense of secrecy. Direct evidence is rarely obtainable. Frequently, it can be shown only by the circumstances admitted by the parties

> to it. Fraud may, and usually must be, proved by circumstantial evidence. The individual circumstances are usually inconclusive and attacked separately may be blown away. The circumstances must ordinarily be considered together, and the force and weight to be given them are that of them in combination.
>
> The circumstances of a bona-fide transaction are ordinarily consistent with each other and with generally recognized business methods and fair dealing, and not incredible. A fraudulent transaction naturally begets stilted, contradictory, and incredible evidence. The bona fide transaction and the fraudulent one each has its well-recognized indicia.

First Nat. Bank v. Hartsock, 202 Iowa 603, 210 N.W. 919, 920 (1926). *See also*, Travelers Indemnity Co. v. Cormaney, 258 Iowa 237, 138 N.W.2d 50, 54 (1965).

NCI alleges a misrepresentation by Sprint of its intent to modify the contract in a way beneficial to NCI. The misrepresentation might be characterized as a misrepresentation of Sprint's intent to negotiate in good faith toward a modification, or, if the facts alleged are true regarding the parties reaching a meeting of the minds on December 3, as a misrepresentation of Sprint's intent to reduce the agreement to the required writing.

The fact apparently misrepresented was the state of mind of defendant's employees. It is this claim of misrepresentation that should have been the focus of Sprint's motion for summary judgment.

Sprint, however, has not met its burden of pointing out with particularity the deficiency in the plaintiff's case so far as plaintiff must show a bar to the use of recoupment. In broad terms, Sprint has contended that NCI has not shown inequitable conduct. This is nothing more than a denial. Sprint's arguments have been primarily directed at countering what Sprint perceived to be a charge by NCI that Sprint had entered into a legally binding oral amendment to the original NCI-Sprint contract. Sprint did not appear to apprehend that NCI alleged misrepresentation as conduct barring the use of recoupment. Sprint did not point to any problems in the plaintiff's brief or supporting materials which tended to show an absence of proof of some important element or elements in plaintiff's case. Under the rules of summary judgment previously set out, this is the minimum burden which a movant for summary judgment must meet to carry its motion.

Second, it appears that resolution of this dispute may hinge on the intent of persons at Sprint. Where intent r state of mind is at issue, courts are reluctant to grant motions for summary judgment.

Although the Eighth Circuit has never addressed the application of summary judgment to a case in which state of mind is an essential element of the non-moving party's claim, a number of circuit courts have dealt with the issue and have uniformly held that courts must normally exercise significant caution when granting such motions. "[A] party's state of mind is inherently a question of fact which turns on credibility. Credibility determinations, of course, are within the province of the fact-finder. Accordingly, we have emphasized repeatedly that cases which turn on the moving party's state of mind are not well suited for summary judgment. [Citations omitted.]" International Shortstop, Inc., 939 F.2d at 1265, giving accord to, Miller v. FDIC, 906 F.2d 972, 974 (4th Cir. 1990) ("general rule that summary judgment is seldom appropriate in cases wherein particular states of mind are decisive elements of a claim or a defense"); Wilson v. Seiter, 893 F.2d 861, 866 (6th Cir. 1990) ("we are aware that state of mind is typically not a proper issue for resolution on summary judgment.") Vacated on other grounds, __U.S.__, 111 S.Ct. 2321, 115 L.Ed.2d 271 (1991); National Union Fire Ins. Co. v. Turtur, 892 F.2d 199 (2nd Cir. 1989) ("questions of intent, we note, are usually inappropriate for disposition on summary judgment"). Several cases note that the likelihood of self-serving testimony,

without the benefits of trial techniques such as cross-examination, is what makes summary judgment motions particularly inapplicable to state of mind questions. International Shortstop, Inc., 939 F.2d at 1265; 60 Ivy Street Corp. v. Alexander, 822 F.2d 1432 (6th Cir. 1987).

IV.

Because of Sprint's failure to demonstrate the inability of NCI to establish one or more of the essential elements of its case regarding misrepresentation, and because of the significance of intent and state of mind in this matter, Sprint's motion for summary judgment should be denied.

ORDER

IT IS ORDERED that the summary judgment motion of U. S. Sprint Communications Co. is denied.

SO ORDERED ON THIS 2nd DAY OF JANUARY, 1992.

William L. Edmonds
Bankruptcy Judge

1. This is not only NCI's standard of proof at trial, but it is also the standard under which the plaintiff's burden is examined on a defendant's motion for summary judgment.