In the United States Bankruptcy Court

for the Northern District of Iowa

GARY L. FEICKERT and DEBORAH J. FEICKERT Debtors.	Bankruptcy No. 96-10007KC Chapter 7
DIANE K. DEMUTH f/k/a DIANE K.D. HANSON Plaintiff vs. GARY L. FEICKERT d/b/a GARY L. FEICKERT CONSTRUCTION Defendant.	Adversary No. 96-1020KC

ORDER

On December 12, 1996, the above-captioned matter came on for trial pursuant to assignment. Plaintiff Diane K. Demuth appeared in person with her attorney, Gregory Epping. Defendant/Debtor Gary L. Feickert appeared in person with his attorney, Janet Hong. Evidence was presented after which the Court took the matter under advisement. The deadline for 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

Debtor Gary Feickert operated a construction company. He performed remodeling services on a home owned by Plaintiff Diane Demuth in 1993. Debtor filed his Chapter 7 bankruptcy petition on January 2, 1996.

This adversary proceeding arises out of the construction agreement between Plaintiff and Debtor. In the process of carrying out his construction agreement, Debtor entered into a subcontract with D & S Sheet Metal, Inc. As a result of the problems with the subcontracting arrangement, Plaintiff and Debtor entered into an indemnity agreement. Plaintiff eventually paid D & S Sheet Metal the sum of $5,000. Plaintiff claims Debtor continues to owe her for reimbursement of this $5,000. She asserts that her claim is excepted from discharge for fraud pursuant to 523(a)(2)(A) and/or defalcation while acting in a fiduciary capacity under 523(a)(4).

FINDINGS OF FACT

Plaintiff Diane Demuth resides in Cedar Rapids, Iowa at 1523 Third Avenue SE. She is a college graduate working in the area of accounting and is presently employed by National Propane.

Plaintiff was previously married to Mark Hanson. While married, she purchased the home on Third Avenue in her own name. Since the purchase of the home, the marriage of Plaintiff and Mark Hansen has been dissolved. Plaintiff continues to own and reside in this home.

In 1993, Plaintiff hired Gary Feickert, a general contractor, to perform restoration on this older home. Initially, the project was primarily designed to replace and restore gutters on the home. The gutter system to drain rain water in this home is enclosed and cannot be viewed externally. The project subsequently expanded. Feickert replaced the roof, performed brick work on an existing chimney, installed new windows, and installed or replaced soffits.

Mr. Feickert is presently 47 years of age and is a general contractor in Cedar Rapids. He has considerable background and experience in this field. He entered into the contract with Plaintiff on a time and materials basis. Pursuant to the contract, Mr. Feickert would submit a bill each week and this would be paid based upon invoices and bills presented to Plaintiff. Throughout the initial restoration process, the accounts were kept current and paid on a regular basis by Plaintiff.

During the course of the project, Mr. Feickert hired D & S Sheet Metal, located in Iowa City, to perform the gutter work on the home. Plaintiff's then husband, Mark Hanson, observed the project on a daily basis. D & S installed a gutter system which was aesthetically inappropriate and did not function properly, according to the testimony of Mr. Hanson and Mr. Feickert. Attempts were made to correct the problems with D & S, but such efforts proved unsuccessful. Eventually, Feickert fired D & S and replaced it with another sheet metal company, TRS, also of Iowa City. TRS performed the gutter work in a less expensive and more satisfactory manner.

On October 28, 1993, D & S Sheet Metal, Inc. filed a mechanic's lien in the Linn County District Court as Mechanic's Lien No. ML10787 against the real estate owned by Plaintiff. Feickert completed his job in September or October of 1993 and submitted a final bill of approximately $11,000. Plaintiff was satisfied with the work as completed. She was concerned, however, about the existence of the mechanic's lien on her property. Seeking assurance that the mechanic's lien would not be a problem for which she was responsible, Plaintiff asked Mr. Feickert to enter into an indemnity agreement addressing possible repercussions from the D & S mechanic's lien.

Both Plaintiff and Mr. Feickert sought the advice of counsel, and an Indemnity Agreement was executed concerning the D & S mechanic's lien. This Indemnity Agreement required Mr. Feickert to defend Plaintiff in all legal proceedings associated with the mechanic's lien foreclosure. The agreement also required Mr. Feickert to indemnify Plaintiff from any loss which she might sustain by reason of any legal action brought by D & S arising out of the subcontract between D & S and Mr. Feickert.

Neither Plaintiff nor Mr. Feickert anticipated that D & S Sheet Metal would pursue the mechanic's lien. Their testimony reflects that they were under the impression that the job quality was so poor that the filing of the mechanic's lien was merely a scare tactic by D & S to attempt to recover some payment. Nevertheless, D & S Sheet Metal eventually filed a mechanic's lien foreclosure action and Plaintiff was served with the foreclosure documents. At that time, the Indemnity Agreement took on new significance.

Both Plaintiff Diane Demuth and Debtor Feickert retained counsel. During the course of much of the litigation. Plaintiff was employed in California but was actively involved in the defense of the action and had counsel throughout the process. Mr. Feickert also had counsel though he did change counsel during the defense of the foreclosure action. The matter proceeded slowly toward trial and a trial date was set for November, 1995.

As a result of the floods of 1993 and other factors, Debtor's business faltered and by the end of 1995, he was contemplating filing a Chapter 7 bankruptcy. At the time the mechanic's lien trial was set, Plaintiff Demuth was still in California. She was made aware by Mr. Feickert that he would be filing a Chapter 7 bankruptcy.

Eventually, the mechanic's lien trial was continued and Plaintiff settled with D & S Sheet Metal by agreeing to pay the sum of $5,000 before a new trial date was reached. She testified that she assumed that the settlement would be cheaper than continuing the litigation. D & S had apparently retained an expert concerning the quality of its work on the project and Plaintiff believed she would have also been required to hire an expert at great cost to rebut this testimony. Additionally, Plaintiff was still in California and the return trip for trial would have been expensive. Finally, she was aware that Mr. Feickert was preparing to file a Chapter 7 bankruptcy and she assumed, all things considered, that it was best to settle the mechanic's lien claim.

Plaintiff asserts that when she entered into the Indemnity Agreement with Mr. Feickert she assumed that she would not have to pay any more money. She claims that through the Indemnity Agreement Mr. Feickert promised to defend Plaintiff and indemnify her from and against any sums due D & S Sheet Metal. As the basis for her fraud claim, Plaintiff further asserts that when Mr. Feickert entered into the agreement, he knew or believed that the representations made were false and he made the representations without any belief that he would perform under the Indemnity Agreement. Alternatively, she asserts that he made the representations in reckless disregard of whether the representations were true or false.

Plaintiff secondly claims that the execution of the Indemnity Agreement created a fiduciary relationship between herself and Mr. Feickert. The Indemnity Agreement created his obligation to defend Plaintiff in all legal proceedings associated with the mechanic's lien and to indemnity her against any sums which might be awarded to D & S Sheet Metal out of its foreclosure action. Plaintiff asserts that Mr. Feickert's failure to pay his attorneys and to present evidence at trial in the foreclosure action constitutes a defalcation of his fiduciary duty under the Indemnity Agreement.

Mr. Feickert testified that he felt the work performed by D & S was inferior and it deserved no payment. He testified: "You fire people for doing this kind of work. You do not pay them." Mr. Feickert stated that when he entered the agreement with Plaintiff, he believed no award would eventually be made to D & S arising out of the mechanic's lien. He testified that he entered into the Indemnity Agreement in good faith. While he admitted that at the time he entered into the Indemnity Agreement he did not have cash reserves sufficient to pay the entire amount of D & S's claim, he did not feel that this was necessary. He did not believe that payment would be necessary. He stated that he intended to meet his obligation if some award was eventually made to D & S.

Mr. Feickert testified that he hired an attorney and paid substantial amounts of attorney's fees to defend the D & S mechanic's lien. He testified also that the course of the litigation extended over two years and that he actively defended it until it was apparent that he was going to be filing a Chapter 7 bankruptcy petition. Mr. Feickert stated that he was advised by counsel that it would be best not to present evidence at any trial. Mr. Feickert related that, at one point, D & S offered to settle for $9,000, which offer he refused. He remembered that he had discussed this with his attorney and he was willing to settle if it was a small amount. However, he refused to pay a substantial amount because of the poor quality of the job.

In summary, Mr. Feickert testified that he entered into the Indemnity Agreement in good faith and defended the litigation to the best of his ability. In so doing, he hired counsel and expended funds for attorney's fees in actively defending the mechanic's lien foreclosure. He testified that he did not make any misrepresentations and that he attempted to abide by the terms of the Indemnity Agreement.

FRAUD - 523(a)(2)(A)

A debt is excepted from discharge pursuant to 523(a)(2)(A) if it is incurred through "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) (1996). A test compromised of five elements determines if a debt should be excepted from discharge under 523(a)(2)(A). In re Hinde, Adv. No. 95-6088KW, slip op. at 4 (Bankr. N.D. Iowa April 19, 1996); In re Stanton, Adv. No. 95-2031KD, slip op. at 3 (Bankr. N.D. Iowa Jan. 10, 1996). These five elements provide that: (1) the debtor made false representations; (2) the debtor knew these representations were false at the time they were made; (3) the debtor made these representations with the intention and purpose of deceiving the creditor; (4) the creditor justifiably relied on these representations; (5) the creditor sustained the alleged injury as a proximate result of the representations having been made. In re Van Horne, 823 F.2d 1285, 1287 (8th Cir. 1987).

Plaintiff has the burden to prove the elements of a claim under 11 U.S.C. 523 by a preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 291, 111 S. Ct. 654, 661 (1991). Exceptions to discharge must be "narrowly construed against the creditor and liberally construed against the debtor. In re Kondora, 194 B.R. 202, 208 (Bankr. N.D. Iowa 1996).

The first element of this test is satisfied if debtor has made a false representation. To find that a debt is nondischargeable on the grounds that debtor made a false representation, debtor must be guilty of positive and actual fraud involving moral turpitude and not implied fraud. In re Weinhardt, 156 B.R. 677, 679 (Bankr. M.D. Fla. 1993). A false representation must "encompass statements that falsely purport to depict current or past facts." In re Spar, 176 B.R. 321, 328 (Bankr. S.D.N.Y. 1994). Mere breach of contract without more does not imply the existence of "actual fraud" sufficient to except a debt from discharge. In re Zachary, 147 B.R. 881, 884 (Bankr. N.D. Tex. 1992). Only when the debtor enters into a contract intending not to comply with its terms, may the debt be excepted from discharge if the other remaining elements of the statutory exception to discharge are satisfied. Id.

Debtor's intent is a critical component of the first three elements of the test under 523(a)(2)(A). Hinde, slip op. at 7. The intent to defraud must have existed at the time the contract was made. In re Hulbert, 150 B.R. 169, 175 (Bankr. S.D. Tex. 1993). In assessing intent, this Court has adopted a totality of the circumstances approach. Id.; In re Davis, No. X91-01771F, slip op. at 7 (Bankr. N.D. Iowa Aug. 21, 1992).

The fourth element of the 523(a)(2)(A) test requires justifiable, not reasonable, reliance. Field v. Mans, 116 S. Ct. 437, 446 (1995). To constitute justifiable reliance, the plaintiff's conduct must not be so utterly unreasonable that the law may say that the loss is plaintiff's own responsibility. In re Vann, 67 F.3d 277, 283 (11th Cir. 1995).

The plaintiff must establish a causal connection between the misrepresentation and the loss suffered in order for a claim to be excepted from discharge under 523(a)(2)(A). In re Kibler, 172 B.R. 740, 742 (Bankr. W.D.N.Y. 1994). Money or services must actually come to the debtor because of the false representation. In re Woodall, 177 B.R. 517, 523 (Bankr. D. Md. 1995). If the facts demonstrate that indebtedness arose out of a contract between the plaintiff and debtor entered without any false misrepresentations by the debtor, no reliance on any false representation exists and no damage has been proven by the plaintiff. Id.

After carefully reviewing the record made, this Court concludes that Plaintiff Demuth has not met her burden of proving each element under the 523(a)(2)(A). The first element requires a showing that Debtor Feickert made a false representation. Plaintiff admitted in her testimony that no misrepresentations were made by Feickert. Any breach of contract made by Mr. Feickert is not sufficient to except Plaintiff's claim from discharge.

The second and third elements of the test require Plaintiff to show that Mr. Feickert knew these representations were false at the time they were made and that he made them with the intention and purpose of deceiving Plaintiff. No false representation has been proven. Looking at the totality of the circumstances, Plaintiff has not demonstrated any intent of Feickert to deceive Plaintiff. Feickert testified that he entered the Indemnity Agreement with good faith and intent to eventually pay any obligation the agreement required. His demeanor during his testimony was sincere. Mr. Feickert's testimony regarding his vehement opposition to filing bankruptcy if he had any other option does not indicate a plan or scheme at the time of the agreement to contract with Plaintiff to indemnify her, defend her for two years and then file bankruptcy. Neither Plaintiff's nor Mr. Feickert's testimony demonstrates that Mr. Feickert made a false representation regarding past or current facts at the time the Indemnity Agreement was entered. Mr. Feickert's failure to fulfill the agreement to pay or indemnify Plaintiff in the future does not preclude discharge of Plaintiff's claim.

Plaintiff has also failed to prove the fourth element of her claim, that she justifiably relied on false representations of Mr. Feickert. Besides the lack of demonstration that false representations were made, Plaintiff did not rely on Mr. Feickert's representations in entering into the Indemnity Agreement. She was represented by counsel in negotiations concerning the Agreement and during the entire litigation process with D & S. Any reliance Plaintiff had when she paid Mr. Feickert the last payment due to him was not based on a false representation. Plaintiff did not dispute that she owed Feickert the amount she paid. She has not shown a false representation in Feickert's promise to indemnify her which induced her to pay the $11,000 for his services.

The fifth element of a 523(a)(2)(A) claim, that the false representations by Feickert were the proximate cause of damage to Plaintiff, has not been proven either. Plaintiff did not pay the money to Feickert because of a false representation. While signing the indemnity agreement may have enabled Feickert to receive money from Plaintiff more rapidly than if Feickert had not signed the agreement, the amount paid to Feickert was based upon a bill for services and materials rendered in Plaintiff's gutter project. If Feickert had not signed the indemnity agreement, he could have recovered that money in a mechanic's lien action similar to the one D & S initiated. Plaintiff has failed to prove any of the five elements necessary to except a debt from discharge under 523(a)(2)(A).

DEFALCATION IN FIDUCIARY CAPACITY - 523(a)(4)

Under 523(a)(4), a debt for "fraud or defalcation while acting in a fiduciary capacity" is excepted from discharge. Two issues are presented in a challenge to dischargeability under 523(a)(4): (1) whether the debtor was acting in a fiduciary capacity and (2) whether fraud or defalcation occurred. Kondora, 194 B.R. at 208; In re Wilson, 127 B.R. 440, 443 (Bankr. E.D. Mo. 1991). Plaintiff has the burden to prove the elements of a claim under 11 U.S.C. 523 by a preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 291, 111 S. Ct. 654, 661 (1991).

The term "fiduciary" in 523(a)(4) applies only to trustees of express or technical trusts. In re Long, 774 F.2d 875, 878 (8th Cir. 1985). Courts look to nonbankruptcy law to determine if such a trust exists. In re Smith, 72 B.R. 61, 62 (N.D. Iowa 1987). This Court has considered circumstances in which a fiduciary duty arises. The class of fiduciary contemplated under 523(a)(4) is a "special class which includes guardians, administrators, executors, public officers, or trustees of an express trust, but does not normally include agents, bailees, brokers, factors or partners." In re Millington, Adv. No. L-91-0078C, slip op. at 25 (Bankr. N.D. Iowa Feb. 10, 1992), aff'd, No. C92-126 (N.D. Iowa Feb. 17, 1994); In re Conley, No. 95-62047KW, slip op. at 6 (Bankr. N.D. Iowa July 15, 1996).

A fiduciary relationship may exist where trust-type obligations are imposed pursuant to statute or common law. In re Van De Water, 180 B.R. 283, 289 (Bankr. D.N.M. 1995). 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). This definition of trust imposes a requirement that there be "some objective manifestation of an intention to create the relationship as defined in the quoted definition." Id. A fiduciary relationship cannot be assumed without an objective manifestation of intent to create it. Id. 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). Recognized examples of fiduciary relationships in Iowa include an individual appointed by a Power of Attorney, and the executor or administrator of a probate estate. Conley, slip op. at 6; Kondora, 194 B.R. at 208.

Indemnity is defined as shifting the responsibility to pay from the shoulders of one person to another. Hunt v. Ernzen, 252 N.W.2d 445, 448 (Iowa 1977). Language in an indemnity agreement should be construed in accordance with its ordinary and commonly accepted meaning. Folkers v. Southwest Leasing, 431 N.W.2d 177, 184 (Iowa App. 1988). Parol evidence is admissible to determine the intention of the parties, the situation of the parties and the objects sought only if the language in the indemnity agreement is subject to more than one meaning.

After determining whether the requisite trust relationship exists under 523(a)(4), the Court must determine whether the debtor's actions constitute fraud or defalcation. Defalcation is evaluated by an objective standard. Kondora, 194 B.R. at 208. It is construed broadly and does not necessarily involve misconduct. In re Smith, 72 B.R. 61, 63 (Bankr. N.D. Iowa 1987). "Negligence or ignorance may be defalcation. No element of intent or bad faith need be shown." Id. (citations omitted). Under the objective standard, neither ignorance of the law nor subjective mental state is relevant. Kondora, 194 B.R. at 208. "Fraud" under 523(a)(4) may only be satisfied by "fraud in fact, involving moral turpitude or intentional wrong, rather than implied or constructive fraud." In re Bryant, 147 B.R. 507, 510 (Bankr. W.D. Mo. 1992).

Plaintiff has the burden of proving that a fiduciary relationship existed between Plaintiff and Mr. Feickert. The Indemnity Agreement did not establish a relationship in which Mr. Feickert had control over the property of Plaintiff. No objective manifestation of intent of the parties to create a fiduciary relationship is present in the Indemnity Agreement. Construing the language of the Agreement in accordance with its plain meaning, it provides that Mr. Feickert is obligated to defend Plaintiff against any legal proceedings and pay any sums due as a result of the subcontracting dispute with D & S. The Indemnity Agreement between the parties did not provide that the money Plaintiff paid to Mr. Feickert would be set aside to pay any legal expenses or possible judgment. No trust account for the funds was established by the agreement. Plaintiff has not met her burden of proving that a fiduciary relationship existed as a result of entering the Indemnity Agreement with Mr. Feickert.

Plaintiff also has the burden of proving that fraud or defalcation occurred. Plaintiff has not proven any fraud on the part of Mr. Feickert. While Mr. Feickert may not have been able to pay the amount due D & S at the time he entered the contract, he operated on a cash flow basis and his testimony indicates he paid his bills as they became due. Since the agreement did not require Mr. Feickert to set the money from Plaintiff aside, the inability to pay the amount due at the time the contract was entered is largely irrelevant and certainly does not constitute fraud.

Defalcation may be negligence or ignorance and does not require misconduct. Mr. Feickert actively defended the mechanic's lien foreclosure for over a year. The only reason Mr. Feickert stopped defending the foreclosure action was because he was financially unable to continue with the foreclosure action after he filed bankruptcy. His conduct since the time he entered the Indemnity Agreement with Plaintiff does not show negligence or ignorance of the law. Plaintiff has failed to prove negligence or ignorance on behalf of Mr. Feickert. Plaintiff's claim is not excepted from discharge under 523(a)(4) as she has failed to prove the existence of a fiduciary relationship or fraud or defalcation.

WHEREFORE, Plaintiff Diane K. Demuth's claim is not excepted from discharge under 523(a)(2)(A).

FURTHER, Plaintiff's claim is not excepted from discharge under 523(a)(4).

FURTHER, judgment is entered for Defendant/Debtor Gary L. Feickert and against Plaintiff Diane K. Demuth.

SO ORDERED this 10th day of January, 1997.

Paul J. Kilburg
U.S. Bankruptcy Judge