

# **In the United States Bankruptcy Court**

## **for the Northern District of Iowa**

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JEFFREY P. CRAWFORD  
MARGERY E. CRAWFORD  
Debtors.

Bankruptcy No. 96-22585D

Chapter 7

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JESSE L. BEBEE  
Plaintiff

Adversary No. 96-2222KD

vs.

JEFFREY P. CRAWFORD  
MARGERY E. CRAWFORD  
Defendant.

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### **ORDER RE: COMPLAINT OBJECTING TO DISCHARGE OF DEBT**

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This matter is before the undersigned for final judgment based on stipulated facts by agreement of the parties. 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).

#### **FINDINGS OF FACT**

Plaintiff Jesse L. Bebee entered into a real estate contract to purchase property from Defendants/Debtors Jeffrey and Margery Crawford. The Crawfords filed a chapter 7 petition on October 9, 1996. Plaintiff asserts that his claims against Debtors based on the real estate contract are nondischargeable pursuant to 11 U.S.C. 523(a)(2), (4) and (6).

The parties filed their Stipulation and Agreement to Submit Matter for Ruling on Stipulated Facts on April 14, 1997. The Stipulation establishes that Debtors owned a four-plex in Dubuque, Iowa. They mortgaged the property with Dubuque Bank & Trust in the principle amount of \$47,500 in October 1993. They then sold the property to Plaintiff in November 1994 for a \$7,000 down payment and the balance of \$44,900 on contract.

Plaintiff bases his claim on two provisions of the real estate contract. The contract states that Debtors could mortgage the premises for up to 90% of the contract balance during the term of the contract. At the time the parties entered into the contract Debtors owed more than the contract balance of \$44,900 on their mortgage with Dubuque Bank & Trust. The Bank subsequently foreclosed the mortgage in early 1997 and received a judgment of \$46,194. Based on these facts, Debtors' mortgage on the property was always more than 90% of the contract balance during the term of the contract.

Another provision of the real estate contract provides that insurance proceeds for past hail damage to the property would be held in escrow until Plaintiff had completed repairs. After repairs were completed, the proceeds in escrow would be turned over to Plaintiff. Debtors cashed the check constituting the hail damage insurance proceeds in the amount of \$8,823.25. They did not place these funds in escrow and have not turned over any of these proceeds to Plaintiff. Debtors assert that Plaintiff repaired the hail damage with used roofing materials and performed substandard workmanship. Even if this assertion might constitute a partial or complete defense to Plaintiff's claim, no evidence appears in the record to support this allegation.

Plaintiff discontinued making payments under the contract in January 1996. He filed an action in Iowa District Court against Debtors in September 1996 to recover for damages under the contract provisions limiting Debtors' mortgage balance to 90% of the contract balance and requiring the insurance proceeds from hail damage to be escrowed.

In both the Iowa District Court action and this nondischargeability adversary proceeding, Plaintiff asserts that he was damaged by Debtors' fraud, misrepresentation and conversion. He requests the Court herein to determine that his claim against Debtors is nondischargeable based on fraud or misrepresentation, embezzlement, and/or willful and malicious conversion under 523(a)(2), (4) and (6), respectively.

### CONCLUSIONS OF LAW

Plaintiff has the burden to prove the elements of a claim under 523(a) 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). These considerations, however, "are applicable only to honest debtors." In re Van Horne, 823 F.2d 1285, 1287 (8th Cir. 1987).

### FRAUD OR MISREPRESENTATION

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." A test comprised of five elements determines if a debt should be excepted from discharge under 523(a)(2)(A). Plaintiff must prove these five elements: (1) the debtor made false representations; (2) the debtor knew these representations were false at the time they were made; (3) the debtor made the representations with the intention and purpose of deceiving the creditor; (4) the creditor justifiably relied on the 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).

To find that a debt is nondischargeable on the grounds that a 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). Some courts hold that a promise related to a future action cannot be defined as a false representation or false pretense. In re Bercier, 934 F.2d 689, 692 (5th Cir. 1991).

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. In In re McLaren, 3 F.3d 958, 963 (6th Cir. 1993), the court found a false representation under 523(a)(2)(A) existed where a debtor had induced payment by falsely representing that the payment would be devoted to a certain acquisition and escrowed for that purpose.

Debtor's intent is a critical component of the first three elements of the test under 523(a)(2)(A). 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.

In re Gessler, 11 B.R. 489 (Bankr. W.D. Wis. 1981), is substantially on point. The debtor, experienced in the real estate business, entered into a real estate contract containing a provision that he would not mortgage the property for more than the contract balance. Id. t 491. The debtor's mortgage exceeded the contract balance at closing and at all times thereafter. Id. at 492. The court concluded that under these circumstances the contract purchaser had relied on the provision which constituted a false statement by the debtor. Id. "Intent to deceive must be inferred from a knowingly made false statement. The debt created by . . . false statement meets the requirements of 523(a)(2)(A) and therefore is nondischargeable." Id. (citations omitted).

## EMBEZZLEMENT

Embezzlement for purposes of 523(a)(4) is the "fraudulent appropriation of property of another by a person to whom such property has been entrusted or into whose hands it has lawfully come." In re Phillips, 882 F.2d 302, 304 (8th Cir. 1989). In order to establish embezzlement, plaintiff must prove that (1) debtor was entrusted with or lawfully came into possession of property of another; (2) debtor was under prior restraint as to use of the property and (3) debtor's use violated the terms of restraint. In re Belfry, 862 F.2d 661, 663 (8th Cir. 1988). Failure to remit proceeds held for another, despite an affirmative duty to do so, constitutes embezzlement. In re Stentz, 197 B.R. 966, 986 (Bankr. D. Neb. 1996).

## CONVERSION

Section 523(a)(6) states that a debtor is not discharged from any debt "for willful and malicious injury by the debtor to another entity or to the property of another entity". A willful and malicious conversion is an "injury" under 523(a)(6). In re Ewing, No. 92-11343LC, Adv. No. 92-1231LC, slip op. at 6 (Bankr. N.D. Iowa Nov. 3, 1993); In re Holtz, 62 B.R. 782, 785 (Bankr. N.D. Iowa 1986). "Bankruptcy Courts must look to state law to define conversion. Iowa defines conversion as 'the act of wrongful control or dominion over chattels in derogation of another's possessory right thereto.'" Holtz, 62 B.R. at 785 (citations omitted).

A mere technical conversion does not satisfy 523(a)(6). Id. at 786. This court in Holtz focused on aggravating features of the debtor's conduct such as the concealment of funds and the deliberateness of the sale after the creditor had attempted to assert its rights in concluding that the debt was nondischargeable. Id. Nondischargeability turns on whether the conduct is (1) headstrong and knowing ("willful") and, (2) targeted at the creditor ("malicious"), at least in the sense that the conduct is certain or almost certain to cause financial harm. In re Long, 774 F.2d 875, 881 (8th Cir. 1985). A willful and malicious conversion under 523(a)(6) occurs when the debtor knowingly converts a creditor's interest in property, knowing the conversion would almost certainly harm the creditor. In re Foust, 52 F.3d 766, 768 (8th Cir. 1995).

In In re Britt, 156 B.R. 511, 517 (Bankr. E.D. Va. 1993), a real estate agent placed a purchaser's funds in an escrow account and subsequently withdrew them for his own personal use. The court found that this constituted fraud under 523(a)(2)(A) as well as conversion constituting willful and malicious injury under 523(a)(6). Id.

## CONCLUSIONS

Debtors' failure to escrow the insurance proceeds as required in the parties' real estate contract constitutes both embezzlement and conversion, making Plaintiff's claim to the insurance proceeds nondischargeable under 523(a)(4) and (6), respectively. Debtors lawfully received the insurance check under a prior restraint to escrow the funds for Plaintiff's benefit. Failing to escrow the funds or turn them over to Plaintiff violated that prior restraint.

Debtors knowingly retained the insurance proceeds in derogation of Plaintiff's rights under the real estate contract, which constitutes conversion. From the record, it is obvious that the provision calling for escrow of the insurance proceeds was negotiated between the parties and fully understood by Debtors. Debtors' unsubstantiated assertion of substandard workmanship in Plaintiff's repairs does not alleviate their known duty to escrow the funds for Plaintiff's benefit pursuant to the contract.

Plaintiff's claim for damages arising from the real estate contract is nondischargeable under 523(a)(2)(A) based on Debtors' failure to abide by the contract provision limiting their right to mortgage the property to 90% of the contract balance. At the time of the contract, Debtors' mortgage balance was more than \$46,000. By entering into the contract, Debtors made a false statement that their mortgage balance was and would continue to be less than 90% of the contract balance, or \$40,410. Plaintiff justifiably relied on this provision, which was typed onto the standard form contract. Debtors' intent to

deceive can be inferred by this knowingly-made false statement, in light of their subsequent failure to comply with the provision.

WHEREFORE, Plaintiff's claim to the insurance proceeds is nondischargeable under 523(a)(4) and (6).

FURTHER, Plaintiff's claim to damages arising from the parties' real estate contract is nondischargeable under 523(a)(2)(A).

SO ORDERED this 23<sup>rd</sup> day of May, 1997.

Paul J. Kilburg, Judge  
U.S. Bankruptcy Court