

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF:)
)
TIMOTHY & MARY JO KURMEL,)
)
Debtor(s).) CASE NO. BK03-82722
A03-8075
JUDITH LETRUD; SHELLY KOEHLER;)
)
& HEARTLAND PHYSICAL THERAPY,)
)
INC.,)
)
Plaintiffs,) CH. 7
)
vs.)
)
TIMOTHY KURMEL,)
)
Defendant.)

MEMORANDUM

This matter is before the court on the debtor-defendant's motion for summary judgment (Fil. #27) and plaintiffs' resistance (Fil. #32), and on the plaintiffs' second motion for summary judgment (Fil. #42) and the debtor-defendant's resistance (Fil. #46). Charles Benish and Gregory Scaglione represent the plaintiffs, and William Biggs and Donald Dworak represent the debtor. The motions were taken under advisement as submitted and without oral arguments.¹ This memorandum contains findings of fact and conclusions of law required by Federal Rule of Bankruptcy Procedure 7052 and Federal Rule of Civil Procedure 52. This is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(I).

The debtor's motion will be denied. The plaintiffs' motion will be granted.

This action was filed to determine the dischargeability of a debt under 11 U.S.C. §§ 523(a)(2)(A) and (a)(4). The individual plaintiffs in the present case are, or at the relevant times were, shareholders, officers, and directors of Heartland Physical Therapy, Inc. The plaintiffs hold a judgment

¹Plaintiffs' first motion for summary judgment was denied in a memorandum and order of May 20, 2004 (Fil. #s 23 and 24), so the court is familiar with the underlying facts of the case.

from the Madison County (Nebraska) District Court for \$378,386.30 against Timothy Kurmel and one of his corporations. They seek to have this amount, plus costs and interest, excepted from discharge as a debt for property obtained by false pretenses, false representations, or actual fraud, or one for fraud or defalcation while acting in a fiduciary capacity.

I. Summary Judgment Standard

Summary judgment is appropriate only if the record, when viewed in the light most favorable to the non-moving party, shows there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. Fed. R. Civ. P. 56(c) (made applicable to adversary proceedings in bankruptcy by Fed. R. Bankr. P. 7056). "We look to the substantive law to determine whether an element is essential to a case, and only disputes over facts that might affect the outcome of the suit under the governing law will properly preclude the entry of summary judgment." Williams v. Marlar (In re Marlar), 252 B.R. 743, 751 (B.A.P. 8th Cir. 2000) (quoting Ries v. Wintz Properties, Inc. (In re Wintz Cos.), 230 B.R. 848, 858 (B.A.P. 8th Cir. 1999)) (internal quotations omitted).

II. Discussion

The debtor's motion asserts that the plaintiffs fail to state a claim under § 523(a)(4) and that the state court judgment does not support a finding of non-dischargeability under § 523(a)(2)(A), while the plaintiffs' motion asserts that the res judicata and collateral estoppel doctrines permit this court to declare the debt to be non-dischargeable under §§ 523(a)(2)(A) and (a)(4) on the basis of the state court judgment.

A state court action to establish a debt is separate from a determination of the dischargeability of that debt in bankruptcy. Tatge v. Tatge (In re Tatge), 212 B.R. 604, 609 (B.A.P. 8th Cir. 1997). The bankruptcy court has exclusive jurisdiction to determine whether debts for debtor's fiduciary or non-fiduciary fraud, willful and malicious injury, or divorce-related property settlement obligations are non-dischargeable. 11 U.S.C. § 523(c); Zio Johnos, Inc. v. Ziadeh (In re Ziadeh), 276 B.R. 614, 619 (Bankr. N.D. Iowa 2002). Therefore, the court must review the state court judgment to see whether it establishes the elements of a prima facie case under § 523. Hobson Mould Works, Inc. v. Madsen (In re Madsen), 195 F.3d 988, 989-90 (8th Cir. 1999).

A. Debtor-defendant's motion

The debtor moves for summary judgment on the basis that the amended complaint fails to state a claim under § 523(a)(4) because it does not allege that he ever acted as a trustee under a technical trust or ever defalcated in connection with any trust funds.

The amended complaint does not specifically allege facts going to each element of § 523(a)(4), but it does allege that Mr. Kurmel "violated various fiduciary duties" in connection with the billings to Heartland, as well as in connection with the nonpayment of payroll taxes and failure to contribute collected 401(k) funds. It also suggests that his actions violated fiduciary duties owed to the individual plaintiffs as corporate shareholders. Such allegations are sufficient to put the defendant on notice of the § 523(a)(4) claims against him.

The debtor also moves for summary judgment on res judicata grounds, arguing that the issues in the state court case were fully litigated and a final judgment entered, so the issues cannot be re-litigated in this adversary proceeding. Mr. Kurmel suggests that the state court did not find that he committed fraud, so the plaintiffs should be precluded from getting a second bite of that apple in this court.

When the parties have previously litigated an issue in a state court, the bankruptcy court will look to state law to determine the preclusive effect of that judgment. Madsen, 195 F.3d at 989-90; Mogley v. Fleming (In re Fleming), 287 B.R. 212, 218-19 (Bankr. E.D. Mo. 2001). In Nebraska, res judicata bars relitigation of any right, fact, or matter directly addressed or necessarily included in a former adjudication if (1) the former judgment was rendered by a court of competent jurisdiction, (2) the former judgment was a final judgment, (3) the former judgment was on the merits, and (4) the same parties or their privies were involved in both actions. State v. Angela W. (In re Marcus W.), 11 Neb. Ct. App. 313, 323, 649 N.W.2d 899, 909 (2002).

To recover on a claim of fraudulent misrepresentation under Nebraska law, a plaintiff must demonstrate (1) that a representation was made; (2) that the representation was false; (3) that when made, the representation was known to be false or made recklessly without knowledge of its truth and as a positive assertion; (4) that it was made with the intention that it should be relied upon; (5) that the party reasonably did so rely; and (6) that he or she suffered damage as a result. Agri

Affiliates, Inc. v. Bones, 265 Neb. 798, 805, 660 N.W.2d 168, 175 (2003).

These elements are precisely what the plaintiffs pled in their state court action. The state court decree does not address each element individually, but the trial judge found that Mr. Kurmel admitted billing personal and non-related business expenses to Heartland (in other words, knowingly making false representations), expecting the plaintiffs to pay those expenses (in other words, intending for them to rely on the false representations), without accounting to them for such expenses even when asked (in other words, causing reasonable reliance and overpayments, to the plaintiffs' detriment).

Therefore, it appears that the trial judge did find that all of the elements of fraudulent misrepresentation had been met and entered judgment accordingly. Therefore, the judgment may serve as the basis for a determination in this proceeding of whether the elements of § 523 have been established. The debtor's motion for summary judgment should be denied.

B. Plaintiffs' motion

The plaintiffs' prior motion for summary judgment was denied because it was not apparent from the face of the state court judgment that it established the elements of a prima facie case under § 523. In support of their second motion, the plaintiffs submitted the transcript from the bench trial. That transcript helps to clarify the basis of the state court decree.

C. Section 523(a)(2)(A)

To prevail in a non-dischargeability action under § 523(a)(2)(A), a creditor must prove by a preponderance of evidence that: (1) the debtor made a false representation; (2) at the time the debtor knew the representation was false; (3) the debtor made the representation deliberately and intentionally with the intention and purpose of deceiving the creditor; (4) the creditor justifiably relied on the representation; and (5) the creditor sustained loss and damage as a proximate result of the representation having been made. Waring v. Austin (In re Austin), 317 B.R. 525, 530 (B.A.P. 8th Cir. 2004) (citing Field v. Mans, 516 U.S. 59 (1995); Grogan v. Garner, 498 U.S. 279 (1991); and Merchants Nat'l Bank of Winona v. Moen (In re Moen), 238 B.R. 785, 790 (B.A.P. 8th Cir. 1999)).

The plaintiffs' § 523(a)(2)(A) allegations concern Mr. Kurmel's fraudulent invoices and overcharges for administrative

expenses. Mr. Kurmel and plaintiff Ms. Letrud were shareholders in Partners in Physical Therapy, Inc. ("Partners"). Through Partners, Mr. Kurmel orally contracted to provide employees to plaintiff Heartland Physical Therapy, in which Mr. Kurmel and plaintiffs Ms. Koehler and Ms. Letrud were shareholders. Mr. Kurmel oversaw all of the operational and financial functions of Partners, in fact operating it as an alter ego. The state court lawsuit dealt with Partners' billing of Heartland for inflated administrative expenses and expenses not properly attributable to Heartland.

The testimony in the state court trial established for the trial judge that Mr. Kurmel admitted charging Heartland for his personal expenses, Partners' expenses that had nothing to do with Heartland, and corporate loans to himself. Ms. Letrud and Ms. Koehler repeatedly sought explanation and clarification of the invoices from Partners, but were given insufficient and inexplicable information. As the Madison County District Court put it,

[W]hen Mr. Kurmel was confronted by the plaintiffs to give them an accounting and formula as to how he was computing the costs billed to the plaintiffs, they were furnished with incomprehensible gibberish. There is absolutely no rhyme or reason or evidence produced by Mr. Kurmel that could clearly establish how he was computing the bills sent to the plaintiffs.

Decree at 2 (Ex. 6 to Scaglione Aff.) (Fil. #43).

In the context of § 523(a)(2)(A), the testimony establishes that Mr. Kurmel made false representations to the plaintiffs by sending them fraudulent invoices. He knew the invoices were false when they were prepared. He intentionally sent the false invoices for the purpose of causing the plaintiffs to pay more than they owed because he needed the money for his personal expenses. The plaintiffs relied on the presumed correctness of the invoices and paid them, resulting in significant overpayments to Partners to Heartland's detriment. For that reason, the debt should be excepted from discharge under 11 U.S.C. § 523(a)(2)(A).

D. Section 523(a)(4)

The plaintiffs also assert that the state court's findings regarding Mr. Kurmel's failure to pay certain payroll taxes and deposit 401(k) plan contributions establish defalcation while acting in a fiduciary capacity, such that § 523(a)(4) would

render the debt non-dischargeable. The decree addresses fiduciary duties in two respects. First, the Madison County district judge found that "Mr. Kurmel violated the trust placed in him by the plaintiffs" by failing to pay final payroll taxes of \$3,313 and 401(k) contributions of \$79,263.30. Second, the judge found, for purposes of piercing the corporate veil and imposing joint and several judgment, that "Mr. Kurmel violated his fiduciary duties to" Ms. Letrud and Ms. Koehler. Decree at 2, 3.

The term "fiduciary" as used in common law or state law is broader than the usage of the term in bankruptcy dischargeability proceedings. Under § 523(a)(4), "fiduciary" is used in the "strict and narrow" sense to refer only to trustees of express trusts. Hunter v. Philpott, 373 F.3d 873, 875-76 (8th Cir. 2004). The substance of a transaction, rather than the labels assigned by the parties, determines whether a fiduciary relationship exists for bankruptcy purposes. Barclay's Am./Bus. Credit, Inc. v. Long (In re Long), 774 F.2d 875, 878 (8th Cir. 1985). "[T]he fiduciary relationship must preexist 'the incident creating the contested debt and apart from it. It is not enough that the trust relationship spring from the act from which the debt arose.'" Hunter, 373 F.3d at 877 (quoting In re Dloogoff, 600 F.2d 166,168 (8th Cir. 1979)).

1. ERISA fiduciary

The Hunter case dealt with a debt owed to a union pension and welfare plan. The debtor was an officer and fifty-percent shareholder of a construction company that signed a collective bargaining agreement with the pension and welfare plans in order to employ union members. The construction company paid some, but not all, of the contributions owed to the plans. When the debtor filed for bankruptcy protection, the pension and welfare plans filed an adversary proceeding seeking a determination that he committed defalcation of the plans' property while serving in a fiduciary capacity. The bankruptcy and district courts ruled in favor of the plans. The appellate court reversed, ruling in part that

We are not satisfied that the simple determination that an individual is an ERISA fiduciary is enough to satisfy the requirements of § 523(a)(4). Instead, we believe that the prior holdings of our court and the United States Supreme Court require that we look specifically at the property that is alleged to have been defalcated to determine whether [the debtor] was legally obligated to hold that specific property for

the benefit of the Funds.

373 F.3d at 875.

While there are a number of references in the trial transcript to Mr. Kurlmel's status as a "fiduciary" for purposes of the trust fund and pension plan contributions, there is no evidence on this record of whether the definition of a fiduciary for ERISA or Internal Revenue purposes is congruous with the definition of a fiduciary for § 523(a)(4) purposes. Therefore, to the extent the plaintiffs may be claiming that Mr. Kurlmel committed defalcation while acting in a fiduciary capacity in connection with the employment taxes and 401(k) contributions, summary judgment must be denied.

2. Corporate fiduciary

In Nebraska, an officer or director of a corporation occupies a fiduciary relation toward the corporation and its stockholders and is treated by the courts as a trustee. An officer or director must comply with the applicable fiduciary duties in his or her dealings with the corporation and its shareholders. Trieweiler v. Sears, 268 Neb. 952, 972-73, 689 N.W.2d 807, 830-31 (2004) (citing Woodward v. Andersen, 261 Neb. 980, 627 N.W.2d 742 (2001) and Doyle v. Union Ins. Co., 202 Neb. 599, 277 N.W.2d 36 (1979)).

Likewise, shareholders in a close corporation owe one another the same fiduciary duty as that owed by one partner to another in a partnership. I.P. Homeowners, Inc. v. Radtke, 5 Neb. Ct. App. 271, 282-83, 558 N.W.2d 582, 589 (1997).

Shareholders in a close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another, to act among themselves in the utmost good faith and loyalty. This reliance on partnership principles is appropriate since many close corporations are in substance partnerships by another name. Unlike the holders of public stock, who can sell their stock when disagreements over management arise, shareholders in a small corporation do not usually have an available market to sell their shares. The mere fact that a business is run as a corporation rather than a partnership does not shield the business venture from a fiduciary duty similar to that of true partners.

Id. (quoting 12B William M. Fletcher, Fletcher Encyclopedia of the Law of Private Corporations § 5713 at 2 (Cum. Supp. 1996)).

The Eighth Circuit Court of Appeals has acknowledged that, aside from trustees of express trusts, state law may create a fiduciary status in an corporate officer which is cognizable in dischargeability proceedings. Long, 774 F.2d at 878. The court went on to note that "[d]raining a corporation's assets for the personal benefit of an officer may thus create a bar to discharge. This is different, however, from making officers fiduciaries with respect to third party creditors[.]" Id. n.3 (internal citations omitted).

Because Mr. Kurmel admitted, and the trial court found, that he breached his duty to the corporate entities and the other shareholders by using the corporation(s) to pay personal debts, I find that he committed defalcation while acting in a fiduciary capacity with respect to the general misuse or misappropriation of corporate funds. For that reason, the debt should be excepted from discharge under 11 U.S.C. § 523(a)(4).

III. Conclusion

The debtor-defendant's motion for summary judgment will be denied. The plaintiff's second motion for summary judgment will be granted on the fraudulent misrepresentation cause of action and on the defalcation-by-a-fiduciary cause of action as it pertains to Mr. Kurmel's breach of the fiduciary duties he owed to the corporations and his fellow shareholders. A separate judgment will be entered.

DATED: January 28, 2005

BY THE COURT:

/s/ Timothy J. Mahoney
Chief Judge

Notice given by the Court to:

*Charles Benish/Gregory Scaglione
William Biggs/Donald Dworak
U.S. Trustee

Movant (*) is responsible for giving notice of this order to all other parties not listed above if required by rule or statute.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF:)
)
TIMOTHY & MARY JO KURMEL,)
)
Debtor(s).) CASE NO. BK03-82722
) A03-8075
JUDITH LETRUD; SHELLY KOEHLER;)
)
& HEARTLAND PHYSICAL THERAPY,)
)
INC.,)
)
Plaintiffs,) CH. 7
)
vs.)
)
TIMOTHY KURMEL,)
)
Defendant.)

JUDGMENT

This matter is before the court on the debtor-defendant's motion for summary judgment (Fil. #27) and plaintiffs' resistance (#32), and on the plaintiffs' second motion for summary judgment (Fil. #42) and the debtor-defendant's resistance (Fil. #46). Charles Benish and Gregory Scaglione represent the plaintiffs, and William Biggs and Donald Dworak represent the debtor.

IT IS ORDERED the plaintiffs' second motion for summary judgment (Fil. #42) is granted. The debtor-defendant's motion for summary judgment (Fil. #27) is denied. In accordance with the Memorandum of today's date, the debt of \$378,386.30, plus post-judgment interest at the statutory rate, is not dischargeable.

DATED: January 28, 2005

BY THE COURT:

/s/ Timothy J. Mahoney
Chief Judge

Notice given by the Court to:

*Charles Benish/Gregory Scaglione
William Biggs/Donald Dworak
U.S. Trustee

Movant (*) is responsible for giving notice of this order to all other parties not listed above if required by rule or statute.