#2577 **signed June 21, 2002**

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS

In Re:	
KENNETH M. CARDWELL,	**CASE NO. 00-41099-7**
DEBTOR.	**CHAPTER 7**
THE MISSION BANK,	
PLAINTIFF,	
v.	**ADV. NO. 00-7108**
KENNETH M. CARDWELL,	
DEFENDANT.	

ORDER DENYING MOTION FOR SUMMARY JUDGMENT, BUT

GRANTING SANCTIONS FOR IMPROPER SERVICE OF PROCESS

This proceeding is before the Court on defendant-debtor Kenneth Cardwell's motion for summary judgment. The defendant-debtor ("the Debtor") appears by counsel Eric C. Rajala. Plaintiff The Mission Bank ("the Bank") appears by counsel Robert A. Andrews of Andrews & Fowler, Chartered. The Court has reviewed the relevant pleadings and is now ready to rule.

FACTS

Except as indicated, the following facts are not controverted.

Before he filed for bankruptcy, the Debtor was the president of a company called American Reprographics, Inc. ("the Corporation"), for a number of years, and owned 70% of its stock. The

Corporation borrowed money from the Bank at various times, and the Debtor personally guaranteed that debt. Around February 1, 1999, the Debtor submitted a personal financial statement to the Bank in which he valued his interest in the Corporation at $1,000,000 as of January 1, 1999. He claims he arrived at this value by using a formula that an accountant had given him in 1993 or so, although the formula is not described in any of the materials submitted by the parties. The financial statement included directions advising the Debtor to inform the Bank if his financial circumstances changed materially.

The Corporation was required to submit annual financial statements to the Bank and it did so for 1993 through 2000, although there is some dispute about the timeliness of the submissions. The Corporation also provided the Bank with a financial statement for the period ending June 30, 1999. The Bank renewed the Corporation's loan in July 1998, July 1999, and several times thereafter. The financial statements show that the Corporation had net income of about $300,000 in 1993, $50,000 in 1994 and again in 1995, and $66,000 in 1996, but then had net losses of about $3,600 in 1997, $1,000 in 1998, and $25,000 for the six-month period ending on June 30, 1999. By July 1999, the Bank officer in charge of the Corporation's loan knew that the Internal Revenue Service had issued levies against the Corporation's accounts in 1998 and that the Corporation had lost a valuable contract with Xerox Corporation late in 1998 or early in 1999.

Because of the Corporation's business difficulties, the Debtor began negotiating with the president of Western Blue Print Company, L.L.C. ("Western"), in 1998 for a possible sale of some of the Corporation's assets. Some of the Corporation's equipment was of no interest to Western because it was becoming technologically obsolete. The Corporation had no restrictions on employees leaving and using its customer list at other jobs, and around the middle of 1998, a sales representative had left the Corporation and gone to work for Western, taking the customer list with her and contacting some of those on the list on Western's behalf. Nevertheless, the Debtor's negotiations with Western led to a lengthy proposed agreement under which Western would pay the Corporation up to $500,000 over five years based almost entirely on Western obtaining business from the Corporation's then-current customers. The proposal included a provision that the Debtor and another person would sign employment agreements with Western. Ultimately, Western decided not to go through with the purchase. The Corporation then lost its lease and essentially went out of business on August 31, 1999, except that the Debtor continued to try to collect its accounts receivable and to liquidate its equipment and inventory.

The Debtor went to work for Western, signing an employment agreement with it the same day the Corporation stopped operating. Under this agreement, the Debtor was to be paid a salary and commissions on business he obtained from new customers or new lines of business he obtained from specified customers of the Corporation. He was also to be paid "Additional Compensation" of up to $500,000 on essentially the same terms as the $500,000 that would have been paid to the Corporation under the purchase agreement that Western finally declined. If the Debtor's position with Western was terminated without cause, or because of his death or disability, he or his estate would still be entitled to be paid the Additional Compensation. Despite these terms, the Debtor insists the Additional Compensation would be paid only because of his contacts with and the personal services he would provide to the Corporation's former customers who would provide the business that would generate the Additional Compensation.

The Bank contends that the Debtor did not disclose to it the Corporation's adverse financial circumstances, and until early in 2000 concealed the fact that the business had been closed the previous August. The Debtor alleges that he kept the Bank's officer informed of the Corporation's situation at all relevant times. The Bank's officer claims that the Debtor first told him that the Corporation would be sold to Western, then told him that the companies would merge, and finally told him in February 2000 that there had been no sale or merger and that the Debtor had signed the employment agreement with Western.

The Debtor filed a chapter 7 bankruptcy petition in May 2000. The Corporation also filed a chapter 7 bankruptcy petition that same month, listing assets of about $190,000 and debts of about $600,000. The assets included about $100,000 in accounts receivable and $43,000 in machinery and equipment. The Bank's officer in charge of the Corporation's loan apparently concluded in February 2000 when the Debtor told him of the employment agreement with Western that the Corporation's stock was then worthless.

When the Bank commenced this adversary proceeding on September 28, 2000, a summons to the Debtor was issued under which the Debtor's answer would have been due on October 30 (because October 28 was a Saturday that year). *See* Fed. R. Bankr. P. 7012(a) & 9006(a). However, the summons and complaint were not served on the Debtor until October 24, when it was finally mailed to him. A non-file-stamped copy of the complaint had been mailed to the Debtor's attorney on the day the complaint was filed, but no summons was ever served on him. On October 26, the Debtor's counsel obtained a Clerk's ten-day extension of the answer time, and filed the Debtor's answer on November 8. Among other things, the answer asserted the defenses of insufficiency of process and of service of process.

The Bank's complaint seeks to except the Debtor's debt to it from discharge, and is divided into two counts, although the first count appears to assert what the Court would classify as two claims. In the first count, the Bank alleges the written financial statement that the Debtor gave it in February 1999 was false, a claim that the Court believes must fall under 11 U.S.C.A. §523(a)(2)(B) to make the debt nondischargeable. The count also alleges that the Debtor failed to disclose the Corporation's adverse financial circumstances to the Bank and concealed until about February 2000 that the business had been closed on August 31, 1999, a claim that the Court believes must fall under §523(a)(2)(A) to make the debt nondischargeable. In the second count, the Bank alleges that the debtor committed a fraud or defalcation while acting in a fiduciary capacity or embezzlement by appropriating the Corporation's customer list and in effect selling it to Western, in violation of §523(a)(4).

The Debtor has now moved for summary judgment on the entire complaint. He contends: (1) the complaint should be dismissed for insufficiency of process and insufficiency of service of process; (2) there is no evidence that his financial statement was materially false when he submitted it to the Bank on February 1, 1999; (3) the Bank did not reasonably rely on his financial statement; (4) the Bank's complaint fails to state a claim on which relief may be granted under §523(a)(2)(A); (5) he did not breach any fiduciary duty to the Corporation or its creditors; and (6) he did not embezzle the Corporation's customer list. The Bank opposes all these claims.

DISCUSSION AND CONCLUSIONS

The Court will begin with the Debtor's attack on the sufficiency of process and service of process. Federal Rule of Bankruptcy Procedure 7004(e) provides in pertinent part: "If service is by any authorized form of mail, the summons and complaint shall be deposited in the mail within 10 days after the summons is issued. If a summons is not timely delivered or mailed, another summons shall be issued and served." The reason for this requirement is made apparent by Rule 7012(a), which fixes the time for a defendant to answer a complaint as 30 days after the issuance of the summons, unless the court prescribes a different time. Requiring a new summons insures that the defendant has a minimum of twenty days (plus three days when service is by mail, Rule 9006(f), minus the time it takes for mail to be delivered) to file an answer. The Bank violated Rule 7004(e). Rather than mailing the summons within 10 days after it was issued, counsel mistakenly placed the summons and complaint in a file and noticed the oversight only when checking for the Debtor's answer date. On discovering the error, instead of obtaining a new summons, counsel simply mailed the stale one six days before the answer date fixed by that summons. Counsel also mailed the summons and complaint only to the Debtor, neglecting to serve his attorney, as required by Rule 7004(b)(9). Although the Debtor's attorney had been provided a copy of the complaint before it was filed, obviously no summons accompanied that premature service. The Rule presumably requires service on a debtor's attorney: (1) to help insure that the debtor is not prejudiced by failing to recognize the significance of the complaint; (2) because the debtor is not likely to be aware that an adversary complaint is different from all the other documents connected with his or her bankruptcy case and would not be sent to the attorney but for Rule 7004(b)(9); and (3) in case the debtor has moved from the last address included in a filed pleading, on the theory that the debtor is likely to keep his or her attorney informed how to contact him or her.

Despite the Bank's failure to properly serve the Debtor and his attorney with the summons and complaint, the protections the Rules were intended to provide were accomplished. Apparently the Debtor quickly advised his attorney that he had received the summons and complaint, and the attorney obtained a clerk's extension of time and was able to file a timely answer.

The Bank blithely argues that the Court should excuse its improper attempt at service or else permit it to perform proper service now because the Bank had no way of knowing how the service was insufficient until the Debtor explained the problem in his motion for summary judgment. In essence, the Bank suggests that although the Debtor raised in his answer the propriety of the service of process, it could not have been expected to review the Rules and the case file, or to contact the Debtor's attorney in an effort to discover its error before the Debtor sought summary judgment. Just reading the summons alone would have given counsel a good clue to the problem because it states that the Debtor had to respond "within 30 days after the date of issuance of this summons."

The Bank's failure to serve the summons and complaint in accordance with the Bankruptcy Rules forced the Debtor to seek an extension of the time to file his answer. The Bank's subsequent failure to investigate and correct its service errors encouraged the Debtor's counsel to seek, in the summary judgment motion, to have this proceeding dismissed. The Court can perceive no other prejudice to the Debtor as a result of the Bank's mistakes, particularly no impairment of his ability to defend the case on the merits. Consequently, the Court concludes that the extreme sanction of dismissal would not be appropriate. Instead, the Court will require the Bank to pay the fees and expenses of the Debtor's counsel that were generated by the errors, that is, those required to obtain the extension of the answer time and to ask for summary judgment on the grounds of insufficiency of process and service of process. The Debtor's counsel is directed to submit an itemization of those fees and expenses within 30 days of the date of this order. The Bank will have 10 days from the date the itemization is served on it to file a written objection specifying any line items it believes should be excluded from this sanction.

The Court will now turn to the substance of the Debtor's summary judgment motion.

As indicated, the first count of the Bank's complaint cites §523(a)(2)(A) and (B). These provisions except from discharge any debt:

> (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; [and]
>
> (B) use of a statement in writing—
>
> (i) that is materially false;
>
> (ii) respecting the debtor's or an insider's financial condition;
>
> (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
>
> (iv) that the debtor caused to be made or published with intent to deceive.

The Debtor contends that the Bank's complaint fails to state a claim for relief under §523(a)(2)(A) because the allegations that the Debtor failed to disclose the Corporation's "adverse financial circumstances" and concealed the closing of the Corporation's business accuse the Debtor of misrepresenting the financial condition of an insider, allegations that are covered, if at all, only by §523(a)(2)(B). The Court agrees with the Debtor that an allegation of failure to disclose "adverse financial circumstances" concerns the Corporation's financial condition and therefore cannot be covered by subsection (A). However, while the fact a business has closed would certainly affect its financial condition, the Court believes concealing that fact could fall under subsection (A), so the Bank's allegation on that point is sufficient to state a claim for relief under (A).

The Debtor claims that the Bank has no evidence that his February 1, 1999, financial statement was materially false. The Bank officer in charge of the Corporation's loan may have testified (some interpretation of the testimony appears to be required to reach that conclusion) that the only evidence the Bank has to show that the $1 million value listed on that financial statement for the Debtor's interest in the Corporation was false when the statement was submitted is the fact the stock was worthless one year later. The Debtor suggests that such evidence is insufficient as a matter of law to establish that the value on his financial statement was false. He then points to other evidence that he contends shows that the Corporation's value decreased precipitously during the year after he gave the Bank the financial statement. In effect, in the Court's view, such an argument concedes that the evidence under attack could support the Bank's claim, but that the fact finder should not make the permissible inference that stock now worth nothing was not worth $1 million one year earlier. The argument might be successful at trial, but does not justify summary judgment in the Debtor's favor.

The Debtor also argues that the Bank did not reasonably rely on the valuation in his financial statement when it renewed and increased the amount of the Corporation's loan. This is so, he says, because the Bank had other information that made clear the Corporation was not worth the amount listed in his financial statement. The Bank responds that it reasonably relied on the financial statement because the Debtor subsequently represented to the Bank's officer that he was going to sell the Corporation for $2 million. The Court believes this is sufficient to preclude resolving the question by summary judgment.

The second count of the Bank's complaint alleges that the Debtor violated §523(a)(4), that is, he committed "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." In effect, the Bank seems to be claiming that when the Debtor's negotiations with Western changed from a sale of the Corporation for up to $500,000 to an employment contract with him under which he could receive up to $500,000 on the same terms, the Debtor in effect sold the Corporation's goodwill, customer list, or both for his own benefit. The Debtor responds that the possible $500,000 in compensation is available to him only if he services the accounts of the customers whose business can make him eligible for the compensation. This claim seems to ignore the fact the compensation is still payable based on the business the relevant customers give to Western even after the Debtor becomes disabled or dies. The Court is convinced that the terms of the proposed sale contract and the employment contract raise a permissible inference that the Debtor has taken something that belonged to the Corporation and sold it for his own benefit, although it is somewhat unclear what that something might have been.

The Tenth Circuit has construed §523(a)(4) more narrowly than the Bank would like the Court to do here. In *Fowler Brothers v. Young (In re Young)*, 91 F.3d 1367, 1371-72 (10th Cir. 1996), the Circuit said:

> The existence of a fiduciary relationship under § 523(a)(4) is determined under federal law. However, state law is relevant to this inquiry. Under this circuit's federal bankruptcy case law, to find that a fiduciary relationship existed under § 523(a)(4), the court must find that the money or property on which the debt at issue was based was entrusted to the debtor. Thus, an express or technical trust must be present for a fiduciary relationship to exist under § 523(a)(4). Neither a general fiduciary duty of confidence, trust, loyalty, and good faith, nor an inequality between the parties' knowledge or bargaining power, is sufficient to establish a fiduciary relationship for purposes of dischargeability. Further, the fiduciary relationship must be shown to exist prior to the creation of the debt in controversy.

91 F.3d at 1371-1372 (citations and internal quotation marks omitted). The Court believes that the ordinary "fiduciary duties" that a corporate officer of a Kansas corporation may owe to the corporation or its creditors are the kind of "general fiduciary duty of confidence, trust, loyalty, and good faith" that the Tenth Circuit meant was not sufficient to constitute the kind of fiduciary relationship that is covered by §523(a)(4). The Bank has also failed to show that the Debtor held whatever asset he may be considered to have sold to Western in any express or technical trust, as required under the fiduciary portion of §523(a)(4).

On the other hand, embezzlement does not require a fiduciary relationship. The Tenth Circuit has said for purposes of §523(a)(4), "[E]mbezzlement is defined under federal common law as 'the fraudulent appropriation of property by a person to whom such property has been entrusted or into whose hands it has lawfully come.'" *Klemens v. Wallace (In re Wallace)*, 840 F.2d 762, 765 (10th Cir. 1988) (quoting *Great American Ins. Co. v. Graziano (In re Graziano)*, 35 B.R. 589, 594 (Bankr.E.D.N.Y. 1983), which was quoting *Gribble v. Carlton (In re Carlton)*, 26 B.R. 202, 205 (Bankr.M.D.Tenn. 1982)). Clearly the Debtor was properly in control of the Corporation's assets. Whatever the asset may have been that the proposed sale contract and the employment contract indicate may have belonged to the Corporation but the Debtor in essence sold to Western for his own benefit, the Court believes sufficient evidence has been presented to permit the fact finder at trial to find that the Debtor embezzled the asset from the Corporation.

For these reasons, the Debtor's motion for summary judgment must be denied, except to the extent that the Bank will be required to reimburse the attorney fees and expenses he incurred because of the Bank's improper service of process.

IT IS SO ORDERED.

Dated at Topeka, Kansas, this _____ day of June, 2002.

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JAMES A. PUSATERI
CHIEF BANKRUPTCY JUDGE