



SO ORDERED.

SIGNED this 10 day of November, 2004.


JANICE MILLER KARLIN
UNITED STATES BANKRUPTCY JUDGE

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS**

IN RE: EMMA GRACE ESCALANTE,

Case No. 03-43052

Chapter 7

Debtor.

MAE MENDEZ,

Plaintiff,

vs.

Adversary No. 04-7062

EMMA GRACE ESCALANTE,

Defendant.

ORDER DENYING MOTION TO DISMISS

Defendant, Emma Escalante (hereafter “Escalante”), has filed a Motion to Dismiss¹ this adversary proceeding on the basis that because Plaintiff, Mae Mendez (hereafter “Mendez”), has no enforceable claim against her, she has no standing to bring an action objecting to her discharge. The Court has

¹Doc. 8.

jurisdiction to hear this matter, as it is a core proceeding.²

I. FINDINGS OF FACT

The facts of this case, in the light most favorable to Plaintiff, are as follows. She and Escalante are sisters. Their terminally ill mother signed a will—drafted by Defendant Escalante’s present attorney in this adversary proceeding—in January 2001, just two weeks before her death. Her mother wanted Escalante, Mendez, and their brother, Charley Day, to receive $1/5^3$ of her estate, each, but was concerned that if Plaintiff received her share outright, it would go to her creditors, since she was then contemplating bankruptcy. Accordingly, Escalante promised her mother and Mendez—i.e., made an oral contract---that she would hold Mendez’s share until such time as Mendez had resolved her financial problems, and would then return to her the $1/5$ share. As a result of that promise to keep Mendez’s share safe, the will bequeathed $3/5$ of her estate to Escalante.

Neither party has provided a copy of the will, or quoted any of its provisions, to the Court, and neither party suggests there was language in the will affirmatively establishing an active or spendthrift trust. That said, Mendez alleges that her mother in effect entrusted Mendez’s inheritance to Escalante in a “constructive trust”⁴ so that each of her children would personally, and equally, benefit—as opposed to their creditors—from the inheritance.

²28 U.S.C. § 1334 (jurisdiction) and 28 U.S.C. § 157(b)(2)(I) (core proceeding).

³Neither party has indicated in the pleadings who received the other $2/5$ of the estate, so the Court assumes that evidence must be irrelevant to the dispute. Neither party has also disclosed why their mother did not give Charlie Day’s share to him, outright, but instead, entrusted his share to Escalante, as well.

⁴This is the term used by Mendez.

Escalante received the \$91,050 inheritance in March 2002, and quickly paid her brother his share, approximately \$30,000, but for reasons not disclosed, has refused to pay her sister her share. Instead, contrary to her mother's wishes, she apparently spent both her own and her sister's inheritance, approximately \$60,000 total, over the course of the next eighteen months, because a review of her bankruptcy schedules, filed in October 2003, shows no segregated account being held for Mendez's benefit. She now wishes to receive a discharge of the debt owed to Mendez constituting the 1/5 share of her mother's estate, which she orally promised her mother she would "safeguard" for Mendez's benefit.

Escalante argues that the agreement she made with Mendez and her mother was in fact illegal, and contrary to public policy, since it in effect called for her to hide, with complicity, Mendez's \$30,000 inheritance in her own name while Mendez filed bankruptcy, lied on her bankruptcy schedules about having received the inheritance, and lied about no one holding money or property in her behalf.⁵ As it turns out, Mendez decided it was not necessary, or appropriate, to file bankruptcy, and did not file. She thus demanded return of the inheritance within a few months after Escalante received it, but Escalante has refused to turn it over to her. The parties were ready for trial in state court on the underlying issues when Escalante filed for bankruptcy protection.

⁵A review of the standard Statement of Financial Affairs (SOFA) and Schedules filed in all cases reveals at least four roadblocks to a debtor hoping to hide such an asset. Question 6(b) of the SOFA seeks information about all property held by a custodian, receiver or court appointed official. Schedule B's lead-in instructions note that disclosure of the name and address of persons holding any of debtor's property is required. Question 19 of Schedule B requires debtors list contingent and non-contingent interest in estates of decedents. Finally, Question 33 of Schedule B, the catch-all provision, requires debtors to disclose any other personal property of any kind not already listed.

Mendez's complaint seeks Debtor's nondischarge, under 11 U.S.C. § 727(a)(2)(A)⁶ for transferring funds to insiders, under § 727(a)(4)(A) for making a false oath, and under § 727(a)(5) for failure to satisfactorily explain loss of assets. Mendez also seeks the nondischarge of just the debt owed to her, under § 523(a)(4) and (a)(6), for defalcation while acting as a fiduciary and for willful and malicious conversion of assets.

II. STANDARD OF REVIEW

Although Defendant does not state the basis under which her Motion to Dismiss is filed, the Court assumes it is brought under Federal Rule of Bankruptcy Procedure 7012(b), which incorporates Federal Rule of Civil Procedure 12(b) into all adversary proceedings. To prevail on a Rule 12(b)(6) motion to dismiss for failure to state a claim, the movant must demonstrate beyond a doubt that there is no set of facts in support of plaintiff's theory of recovery that would entitle plaintiff to relief.⁷ All well-pleaded allegations will be accepted as true and will be construed in the light most favorable to Plaintiff.⁸

Plaintiff correctly notes, however, that because Defendant has referred to matters outside the pleadings, disposition under Fed. R. Bankr. P. 7012(b) is inappropriate if the Court relies on those outside matters. Instead, when the Court is asked to, and does, examine matters outside the pleadings, the court must proceed under Fed. R. Bankr. P. 7056, which incorporates the summary judgment standard of Fed. R. Civ. P. 56. Rule 56(c) provides that judgment shall be rendered if all pleadings, depositions, answers

⁶All statutory references are to the Bankruptcy Code, 11 U.S.C. § 101, et seq., unless otherwise specified.

⁷*Jacobs, Visconsi & Jacobs, Co. v. City of Lawrence, Kansas*, 927 F.2d 1111, 1115 (10th Cir. 1991).

⁸*In re American Freight System, Inc.*, 179 B.R. 952, 956 (Bankr. D. Kan. 1995).

to interrogatories, and admissions and affidavits on file show that there are no genuine issues of any material fact, and the moving party is entitled to judgment as a matter of law.

In determining whether any genuine issues of material fact exist, the Court must construe the record liberally in favor of the party opposing the summary judgment.⁹ An issue is "genuine" if sufficient evidence exists on each side "so that a rational trier of fact could resolve the issue either way" and "[a]n issue of fact is 'material' if under the substantive law it is essential to the proper disposition of the claim."¹⁰

Because both parties have cited to potential evidence outside the pleadings, the Court could assume that the parties have stipulated to this additional evidence being considered by this Court, and instead treat the Motion to Dismiss as one for summary judgment. The problem with this procedure, however, is that neither side has followed the requisites for such a motion. There are no numbered paragraphs containing facts about which the parties claim no genuine issue exists, nor the requisite citation to the record, and certain documents that were attached to the Complaint are not otherwise admissible, because no foundation has been laid, and no affidavit has been provided to authenticate them. It is very difficult, if not impossible, to discern with certainty what facts the parties agree to, and which they dispute. For that reason, this Court elects to treat this matter purely as a motion to dismiss. It will exclude the supplemental matters and review the motion to dismiss based solely on the pleadings.

III. CONCLUSIONS OF LAW

Defendant argues that Mendez cannot state a claim for which relief can be granted, because the oral contract she asks this Court to enforce—for Defendant Escalante to hold Mendez's share of the family

⁹*Adler v. Wal-Mart Stores, Inc.*, 144 F.3d 664, 670 (10th Cir.1998).

¹⁰*Id.*

inheritance until Mendez could receive a discharge of her debts, after filing a bankruptcy she was contemplating at the time of her mother's death---is against public policy. She argues that because this was an unlawful conspiracy—to which she never denies she was a willing participant—this Court must refuse to aid either party to profit by the agreement, and dismiss the case. She cites cases supporting the unremarkable legal proposition that courts should not be used to enforce any agreement or contract entered into in violation of law.

In response, Plaintiff argues that neither she nor her mother had any motive to violate the law when she entered into the agreement with Escalante and her mother, and that no one intended to defraud her creditors. She cites to cases stating that it is not contrary to public policy for testators to create wills that protect their assets from claims by their legatees' creditors, by establishing spendthrift clauses or other kinds of trusts in wills. She argues from those cases that there was, in effect, a “constructive trust,” and that the agreement is therefore enforceable.

This Court does not have before it the contents of the will in question, and neither party has briefed the issue whether the will and surrounding circumstances in this case constitute a constructive trust.¹¹ No one has even set forth the elements of a constructive trust. The only issue before this Court at this time is whether the agreement between the parties is, under any set of facts, enforceable. In evaluating that question, the Court recognizes that there exists a high threshold for voiding a freely made contract between two parties on public policy grounds.¹²

¹¹Plaintiff admits that she does not argue here “that a spendthrift trust was created.” Doc. 10, page 9.

¹²*Cf. Society of Lloyd's v. Mullin*, 255 F. Supp.2d 468, 476 (E.D. Pa. 2003).

Plaintiff is correct that if drafted and executed properly, some trusts established to protect a testator's assets from payment of a creditor of a legatee may be exempt from execution by creditors, and from claims by a bankruptcy trustee, on the theory that "a creditor of the donee has no right to look to the property of another man for the payment of his debts."¹³ The Kansas Supreme Court has noted that

"[a]s to past debts, such creditors are no worse off after their debtor becomes the donee of a spendthrift trust than they were before, and as to future debts it is their own folly if they choose to rely upon a fund which by the very terms of its donation it is impossible for them to reach, of which fact they are advised actually or constructively by the registry laws of the United States. Moreover, it is not deemed against public policy for a testator to provide a support for a spendthrift child, since it is the interest of the public that such child shall not become a public burden. The rights of creditors are not deemed any more sacred than the right of property involved in the execution of the trust; or the right which a testator has that the will he made should be carried out, and not one that the court makes for him."¹⁴

Because the Court does not have the will in question, nor the benefit of the parties' briefs on the issue of will substitutes by oral contract, or constructive trusts, this Court simply has not been provided sufficient information to be able to decide that, as a matter of law, under any set of facts, the transaction is contrary to public policy, and void.

On the issue of whether the purported agreement is void as contrary to public policy, the United States Supreme Court has weighed in on a somewhat similar, but by all means not identical, fact pattern in the case of *Block v. Darling*.¹⁵ Darling sued Block to recover the remaining \$5,000 purchase money due from the sale of his business to Block. To defeat collection of that amount, Block attempted to present evidence that the reason it was holding the balance was as a result of a side-agreement between the parties

¹³*Sherman v. Havens*, 94 Kan. 654, 657 (1915).

¹⁴*Id.* at 658.

¹⁵140 U.S. 234 (1891).

whereby Block would hold the money so that Darling’s creditors would not know of this potential asset. The lower court declined to admit the evidence of Darling’s purported intent to defraud creditors, and in affirming that decision, the Supreme Court noted that

“plaintiff’s suit to compel the return of the money may be regarded as one in disaffirmance of the arrangement under which the defendants claimed to have received it; and, if successful, would tend to defeat the alleged purpose of defrauding his creditors by having it kept upon secret deposit with the defendants. It is not a suit to recover money received and paid out under an illegal or immoral contract which has been fully executed. The suit is necessarily a disavowal upon the part of the plaintiff of any purpose to hide this money from his creditors. To allow the defendants to retain it upon the ground that he had originally the purpose to conceal it from his creditors would be inconsistent with the spirit and policy of the law.”¹⁶

Likewise, impliedly in these pleadings, Mendez seems to assert that she had second thoughts about taking bankruptcy—and in fact never did so—and thus if she ever had formed an intent to defraud creditors by not disclosing this inheritance, that never came to fruition. If Mendez were to recover and collect a judgment against her sister for \$30,000, Mendez’s creditors would likely be entitled to collect against that asset, which would not be contrary to public policy.

The Court certainly does not, by declining at this juncture to dismiss this case, find, or even hint that Plaintiff will ultimately prevail in this proceeding.¹⁷ Instead, I only hold that Mendez’ complaint on its face

¹⁶*Id.* at 239.

¹⁷This appears to be an action to enforce an implied or constructive trust based on an oral contract. *See, e.g., Pownall v. Connell*, 155 Kan. 128 (1942), or *Heck v. Archer*, 23 Kan. App.2d 57 (1996). Although the parties do not so state, the Court assumes Mendez had the opportunity, but declined, to timely object to probate of the will. In addition, since neither party has suggested there is language in the will establishing a trust, and because typically parol or extrinsic evidence is inadmissible to explain or to vary the terms of a clear and unambiguous written instrument, the Court does not know if Mendez can ultimately prove the existence of a trust. *In re Estate of Chronister*, 203 Kan. 366, 374 (1969). All of these troubling legal questions, however, must await further factual development, and briefing, by the parties.

states a colorable claim for relief, barring dismissal at this time under Fed. R. Bankr. P. 7012(b).

IV. FURTHER INVOLVEMENT OF DEBTOR'S ATTORNEY

Plaintiff's brief in opposition to the Motion to Dismiss asks, in passing, that this Court disqualify F.G. Manzanares as counsel for Defendant/Debtor Escalante on the basis that he is a potential witness, having personal knowledge of the underlying transaction. She alleges Mr. Manzanares drafted the will in question, and thus has first hand knowledge of the testator's intent. Plaintiff argues that "[s]urely, Defendant's attorney would not advise his client [Mrs. Day, the parties' mother] to create a contract that was against public policy and then later use that contract against one of the beneficiaries of his client's will [Mendez] for the benefit of one of the other beneficiaries [Escalante], now also his client."¹⁸

Because there is no formal motion to disqualify before this Court, and because Mr. Manzanares may not have thought he needed to respond to the request, which was tucked within the response to the motion to dismiss, the Court declines to now rule on this issue, without prejudice to Plaintiff raising the issue in a proper motion. Needless to say, however, this Court requests Defendant's counsel evaluate his continued representation in the case, in light of the Court's decision not to dismiss the case at this early stage of the proceedings.

V. CONCLUSION

On the surface, this Court is faced with ultimately deciding between the lesser of two evils. If Plaintiff's story is true, it is a story of one sister stealing another sister's share of their mother's estate, denying their mother's dying wish that her children share equally in her estate. If Defendant's story is true,

¹⁸Doc. 10, page 10.

it is a story of a sister intending to commit bankruptcy fraud by hiding assets from her creditors. The resolution of these issues must await either a properly filed summary judgment motion, or a trial, where there can be a full development of the facts, because the limited facts set forth in the pleadings, taken in the light most favorable to Plaintiff, demonstrate a colorable claim for relief. For that reason, Defendant's Motion to Dismiss is denied.

Pursuant to Fed. R. Bankr. P. 7012(a), Defendant's answer to Plaintiff's Complaint shall be filed ten days after notice of the court's action herein. The Court also sets this matter for a Scheduling Conference on **December 8, 2004 at 3:00 p.m.** in Room 215, United States Bankruptcy Court, 444 S.E. Quincy, Topeka, Kansas. Counsel shall comply with Fed. R. Civ. P. 26(f) by conferring in person or by telephone not later than November 24, 2004, and counsel for Plaintiff shall file, by **December 3, 2004**, a Report of the Parties' Planning Meeting.

IT IS SO ORDERED.

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