UNITED STATES BANKRUPTCY COURT

DISTRICT OF ARIZONA

In Re CYRIL H. KOBEY, JR. and MARILYNN J. KOBEY, Debtors.	Chapter 7 No. 00-01543-PHX-GBN Adversary No. 01-859
TRADESOURCE, INC., Plaintiff, vs. CYRIL H. KOBEY, JR. and MARILYNN J. KOBEY, Defendants.	FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

Plaintiff's complaint seeking to determine the dischargeability of its claim of $17,287.70 was tried to the court as a bench trial on April 22, June 10 and August 16, 2002. Final briefs were filed and closing argument was presented on October 1, 2002. An interim order was entered on October 30, 2002 announcing the court's decision.

The court has considered the joint pretrial statement of December 27, 2001, closing briefs, declarations and testimony of

witnesses, admitted exhibits and the facts and circumstances of this proceeding. The following findings and conclusions are entered:

FINDINGS OF FACT

1. Tradesource, Inc. ("plaintiff" or "TSI") is a family owned corporation engaged in the barter exchange business as a third-party record keeper for its approximately 800 members. When a member provides a product or a service to another member, the transaction is reported to TSI. No money is exchanged between the members. The party providing the product or service earns a credit for its account. Account credits can be used to obtain goods or services from other members. The party's account is then debited. TSI has reciprocal trading agreements with similar barter entities worldwide.

A member's account is required to have a positive balance of credits over debits, although TSI will temporarily allow a negative account balance. Plaintiff earns a 10-12% commission on transactions, as well as a five-dollar monthly fee. The company employs brokers, supervised by TSI President Mary Ellen Rosinski, to assist members in locating desired goods and services. Restaurant meal availability is an important offering to clients. Testimony ("test") of Mary Ellen Rosinski of April 22, 2002.

2. Marilyn's First Mexican Restaurant, Inc., owned by Cyril H. Kobey, Jr. and Marilynn J. Kobey, was a TSI corporate client since January 18, 1997. Exhibit A. The corporate membership agreement for account 1605 listed both Mr. And Mrs. Kobey as

cardholders. A cardholder is the person authorized to acquire goods and services through the account. Only Mr. Kobey signed the agreement. He signed as a corporate officer, who also personally guaranteed all corporate account obligations.[1] Exhibit A, *id.* At the time Kobey signed the corporate agreement, Marilyn's First Mexican Restaurant, Inc. was a Chapter 11 debtor in possession. Debtor had just confirmed a plan of reorganization on December 31, 1996. Docket for Arizona bankruptcy case 96-02855-Phx-SSC. Defendants' corporation filed bankruptcy on March 25, 1996. *Id.*

Although the corporation was the TSI account client, it was defendants and their family that personally benefited from the account, by receiving goods and services through trades of credits generated by restaurant operations. Test. of Cyril Kobey of April 22, 2002. Defendants' purpose in joining the TSI system, through the corporation, was to obtain *inter alia,* home improvements for their personal residence. The home was "falling apart." Test. Id. Mrs. Kobey also participated in TSI account transactions for her personal benefit, such as meals in other restaurants, home furnishings and tile work at the residence. She debited the account and used restaurant script, although she was not a signatory on the account. She and her husband used account 1605 even though they had jointly filed a personal chapter 13 bankruptcy case on February 17, 2000. Their purchases on the account ultimately created a negative corporate balance. June 10, 2002 test. of Marilynn J. Kobey; Docket

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[1] Mr. Kobey testified he signed the agreement on January 18, 1997 and that his 1996 dating of the agreement was erroneous. Test of Cyril H. Kobey, Jr. of April 22, 2002.

for Arizona bankruptcy case 00-1543-Phx-GBN.

3. The last active transaction for account 1605 occurred on March 1, 2001 when TSI terminated account purchase privileges after its officers learned of the bankruptcy cases. Test. of Mary Ellen Rosinski, *supra;* Exhibit B at p. 1. The account closed with an unpaid deficit of $17,287.70. Exhibit G.

4. If a client exceeds its credit limit, TSI either decides to increase the credit line or requires the member to submit a loan application to cover the negative balance. Plaintiff does not accept for membership persons or companies that are presently insolvent or in bankruptcy. If a member subsequently becomes insolvent or bankrupt, it is denied a credit line and is not allowed to purchase beyond the amount of the account's positive balance. The reason a bankruptcy debtor cannot be a member is that TSI is responsible for replacing deficits in the system. Test. of Mary Ellen Rosinski.

5. In March of 2001, TSI received an Arizona bankruptcy court notice indicating the Kobeys had earlier filed bankruptcy on February 17, 2000. Docket, *id.* This prompted plaintiff's decision to disallow further spending from account 1605. Mary Ellen Rosinski credibly testified that this was the first time TSI learned that defendants or their business had filed bankruptcy. Test., *supra.*

Starting in April of 1997, the corporate account was used to purchase personal items for the Kobeys, using credits generated from restaurant sales. For most of the account's history, purchases generally balanced or were below credits, creating a positive

balance with only minimal credit extensions from TSI. Test., *supra*.

6. Starting in 2000, account usage changed. Defendants began spending both in larger amounts and more frequently. Mr. Kobey asked to pay his membership and commission fees in credits, rather than cash, which further reduced the credit balance. All charges were made either by defendants or their children. Test. *supra*. In August 2000, defendants reported no sales to other members, but obtained $6,207.94 in purchases and fees. This exhausted their previous positive balance of $3,707.11 and their $1,000 credit line, creating a negative balance of $1,500.83. Exhibit 1 at August 2000 statement. TSI allowed trading on this negative balance, believing the account remained viable. In September of 2000, defendants generated $1,591.90 in credit through restaurant sales, but made purchases of $2,788 and accrued trading fees of $278.30. This resulted in a deficit of $3,975.23 over the original $1,000 credit line. Test. of Mary Ellen Rosinski of April 22, 2002; Exhibit 1 at September statement.

Ms. Rosinski credibly testified that had she known that defendants or their corporation was in bankruptcy, she would not have allowed the deficit spending. Test., *supra*.

7. Defendants' deficit spending continued in October of 2000. The account was credited with sales of $1,860, but purchases of more than $3,000 were made. Exhibit B at page 2 of 9. The October deficit of $6,779.42 carried into November, which had credits of $413.39 and purchases of $11,952.14. November purchases included an

expensive tile home improvement project at defendants' home. Exhibit 1 at November statement. A deficit balance of $18,318.17 resulted. *Id.*

TSI and defendants made special arrangements to allow the expensive home improvement project as a $15,000 credit line extension. When plaintiff increased the credit line in September 2000, it was unaware of the pending bankruptcies, Ms. Rosinski credibly testified. Direct test., *supra*. In December 2000, the restaurant had a sales credit of $190.56, purchases of $1,379.84 and fees of $376.99. This created a deficit balance of $19,507.45, even with the $15,000 credit line extension. Exhibit 1 at December statement. Plaintiff did not require a credit application or conduct a new credit investigation when it increased the credit line or allowed defendants to exceed the credit line.

Plaintiff expected the deficits to cease after the home renovation project was completed. Test. In January 2001, defendants decreased the account negative balance by credits of $2,185. However, $1,355.25 in purchases and fees also occurred. *Id.* at January statement.

8. By February of 2001, the deficit had grown to $18,682.70 in six months. On March 29, 2001, defendants voluntarily converted their personal chapter 13 case, which had been pending since February 17, 2000, to the current chapter 7 proceeding. Docket *supra*.

9. The credit line was both increased and allowed to be exceeded because TSI management knew in advance defendants intended

to use bartered services to extensively repair their home. Management did so because it was felt important to keep defendants' popular restaurant actively participating in the barter system. If TSI had concerns over the corporation's credit worthiness, management would have required defendants to execute a form promissory note. Management would also have sought collateral security for the deficit, if it had concerns over the restaurant's financial health. TSI had no such concerns, because it had assurances, through its brokers' contact with defendants, that all was well. Plaintiff subsequently learned that the restaurant had closed in January of 2001. Management spoke to defendant Cyril Kobey, who assured that the restaurant would reopen after a landlord dispute was resolved. The restaurant never reopened.

Defendant Cyril Kobey was asked to return restaurant credit script, which he had been spending for his personal use. He did so in March of 2001. The account was accordingly credited. Test. of Sylvia and Mary Ellen Rosinski. Prior to the restaurant closing and prior to learning of the bankruptcies, defendants and the Rosinski family had a friendly social relationship going back to 1997. Test of Sylvia Rosinski. From plaintiff's perspective, the fraud and misrepresentation were defendants' failure to advise them of the pending corporate and personal bankruptcies at the time defendants were exceeding credit limits with their personal spending. Test. of Mary Ellen and Sylvia Rosinski, *supra*. While the account was in the corporation's name, defendants and their family benefited from personal spending through use of corporate credits. April 22 test.

of Cyril Kobey.

10. In January of 1997 when Cyril Kobey signed the TSI membership agreement and personally guaranteed the corporation's account obligations, he knew the restaurant was still in Chapter 11, operating under a reorganization plan confirmed just the month before. Kobey test.; administrative docket for 96-02855-Phx-SSC at docket item 110. Bankruptcy Court jurisdiction continued while the restaurant made payments pursuant to the plan. Confirmation Order of December 31, 1996 at p. 7 ¶ 7, docket *id.*

The reorganization failed. A chapter 7 liquidation case was filed for the corporation on July 29,1998. *Administrative file* docket ("dkt") no. 1 for 98-9503-Phx-RJH. Bankruptcy trustee Mason operated the restaurant by order of August 7, 1998 until conversion of the case to chapter 11 on May 11, 1999. Dkt 6, 77. A second chapter 11 plan was confirmed on September 21, 1999. Dkt 157. Defendants filed a personal Chapter 13 bankruptcy case on February 17, 2000. Dkt 1 for 00-1543-Phx-GBN. Since plaintiff was not listed as a creditor in any of the three bankruptcy cases, it received no bankruptcy notices from the court. Administrative dockets, *supra*.

However when defendants' personal case was converted to chapter 7 on March 29, 2001, they scheduled plaintiff for the first time as a creditor. Dkt 12-14, exhibit F at p.26. Plaintiff's officers credibly testified the chapter 7 conversion notice was the first indication defendants or their restaurant were in bankruptcy. Test. of Mary Ellen and Sylvia Rosinski. Also *see* deposition test. of Ruthann Goldsmith, adversary dkt 34, at p. 2.

11. Cyril Kobey testified defendants did not advise Chapter 13 trustee McDonald of the significant home renovation they obtained on credit from TSI, as they were unaware his permission was required for such a post petition credit transaction. Defendant Kobey felt the credit transactions on the account created a corporate debt only, although the transactions benefited defendants personally. Nonetheless this "corporate" debt was scheduled by defendants as their personal debt when their chapter 13 case converted to chapter 7. At the time of the March 29, 2001 conversion, defendants had acquired more personal debt than they had when they originally filed for chapter 13 relief. Test.

12. On September 30, 1998, barter account 1835 was established as a sub-account for account 1605 in the name of Marilyn's First Mexican Restaurant, Inc. "Cy" Kobey was the only individual authorized to trade in the account. Exhibit H. Mr. Kobey's testimony is that the sub account was created by TSI after he informed Sylvia Rosinski his restaurant was in Chapter 7. Ms. Rosinski strongly denies this. Test. of August 16, 2002. The Court does not find Mr. Kobey's testimony credible.

13. Account 1835 was entirely funded by credits generated from restaurant operations, that were transferred from account 1605. Exhibit I. Debit purchases through account 1835 were entirely for Mr. Kobey's personal benefit, such as $1,550 for golf clubs and $450 for a Seiko watch in October of 1998. Kobey test.; Exhibit I. Mr. Kobey did not inform chapter 7 trustee Mason that credits belonging to the restaurant had been transferred into account 1835

and used for personal purchases. He doubts the corporation's trustee has ever learned of this use of bankruptcy estate property. The account was closed and the remaining credits transferred back to account 1605 after the corporate case was converted to chapter 11. Test.

14. It is Mr. Kobey's testimony that account 1835 was established by TSI when he informed Sylvia Rosinski of the business bankruptcy. It is his testimony that the account was originated by TSI so the Kobeys could continue to belong to the barter network, even though the business was in bankruptcy. Test. It is noted, however, that the sub account was set up in the bankrupt corporation's name and funded by restaurant credits. Exhibits H, I. He denies the account was established to mask use of corporate credits for personal use by the family, after the chapter 7 trustee instructed defendants to cease accepting TSI credits and script for meals at the restaurant. The fact finder does not consider this testimony credible.

15. Although Mr. Kobey was instructed by trustee Mason in the summer of 1998 to stop accepting TSI credits and script for meals, by October of that year the restaurant had still accepted $1,500 worth of script from TSI clients. On December 16, 1998, $3,000 in restaurant script was transferred to TSI for credit on account 1605. Exhibit B at p.7; Exhibit I.

Mr. Kobey terms subsequent acceptance of script and transfer to TSI for credit an inadvertent violation of the trustee's instructions.

16. Marilynn J. Kobey testified that she and her husband made debit purchases on account 1605 for their personal benefit. In her deposition of April 14, 2002 she testified she never informed the Rosinski family or anyone else, that defendants or their corporation was in bankruptcy.

However it was her trial testimony that she told TSI broker "Ruthann" about the bankruptcies. This occurred in a conversation involving how Kobey daughter Nicole had personally located an attorney to handle conversion of the restaurant bankruptcy. She is unable to recall the date of this conversation or Ruthann's last name. She did not intend this conversation to serve as formal notice to TSI of the bankruptcies. She simply intended to tell Ruthann about her daughter's abilities. Test. The fact finder does not consider this testimony credible. It is noted that broker Ruthann Goldsmith has no recollection of such a conversation. Dkt 34, *supra*.

17. Ms. Kobey testified that although she was the president of the family corporation, she delegated all business and financial affairs to her husband. She primarily dealt with food preparation and staff matters. She knew spending of TSI credits for personal use and home improvements constituted a use of credit while in bankruptcy. She denies knowing this was improper. Ms. Kobey was expressly given permission from Sylvia Rosinski to exceed the account credit line in order to conduct the home improvement project.

While Ms. Kobey did not tell Sylvia directly that defendants

and their corporation were in bankruptcy, she believes her husband's claim he did so. Ms. Kobey was not present when Mr. Kobey, she believes, informed Sylvia of the bankruptcy. She denies personally misleading anyone about the bankruptcies. Test. No contrary evidence concerning Mrs. Kobey's state of mind was produced by plaintiff. The Court finds her testimony credible on this point.

18. To the extent any of the following conclusions of law should be considered findings of fact, they are hereby incorporated by reference.

CONCLUSIONS OF LAW

1. To the extent any of the above findings of fact should be considered conclusions of law, they are hereby incorporated by reference.

2. Pursuant to 28 U.S.C. § 1334(a), jurisdiction of this bankruptcy case is vested in the United States District Court for the District of Arizona. That court has referred, through 28 U.S.C. §157(a), all cases under title 11 of the United States Code and all adversary proceedings arising under title 11 or related to a bankruptcy case to this court. Amended District Court General Order of May 20, 1985. This proceeding having been appropriately referred, this court has jurisdiction to determine whether to grant defendants a bankruptcy discharge of plaintiff's claim.

3. Jurisdiction between the district and bankruptcy courts is based on the distinction between core and non-core bankruptcy matters. Core matters arise under title 11 or arise in a case filed

under chapter 11. The determination of the dischargeability of plaintiff's bankruptcy claim is a core proceeding. 28 U.S.C. § 157(b) (2) (I). Accordingly this court will enter a final judgment. 28 U.S.C. § 157(b)(1).

4. Conclusions of law are reviewed de novo. Factual findings are reviewed for clear error. American Law Center P.C. v. Stanley (In re Jastrem), 253 F.3d 438, 441 (9th Cir. 2001).

5. The standard of proof required of a plaintiff in dischargeability litigation is the preponderance of the evidence. This standard applies to all dischargeability proceedings, without exception. Branam v. Crowder (In re Branam), 226 B.R. 45,52 (9th Cir. Bankr. 1998), *aff'd* 205 F.3d 1350 (9th Cir. 1999), citing Grogan v. Garner, 498 U.S. 279, 111 S. Ct. 654 (1991).

6. Under 11 U.S.C. § 523 (a) (2) (A) a debt for services, money or property obtained by a debtor by false pretenses, a false representation or actual fraud is nondischargeable. The purposes of this provision are to prevent a debtor from retaining the benefits of property obtained by fraudulent means and ensure the relief intended for honest debtors does not go to dishonest debtors. The Ninth Circuit has consistently held that a creditor must demonstrate five elements to prevail on a claim arising under § 523 (a)(2)(A). The five elements, each of which must be established by a preponderance of the evidence, are: (1) misrepresentation, fraudulent omission or deceptive conduct; (2) knowledge of the falsity or deceptiveness; (3) an intent to deceive; (4) justifiable reliance on the statement or conduct and (5) damage to the creditor

proximately caused by reliance. Turtle Rock Meadows Homeowners Association v. Slyman (In re Slyman), 234 F.3d 1081, 1085 (9th Cir. 2000).

7. Reckless disregard for the truth of a representation satisfies the element that debtor has made an intentionally false representation. Advanta National Bank v. Kong (In re Kong), 239 B.R. 815, 826 (9th Cir. Bankr. 1999). Intent to deceive can be inferred from the totality of the circumstances, including reckless disregard for the truth. Gertsch v. Johnson & Johnson Finance Corporation (In re Gertsch), 237 B.R. 160,167-68 (9th Cir. Bankr. 1999) (§ 523 (a)(2)(B) case). The Court concludes from the totality of the circumstances presented through testimony and exhibits that defendant Cyril H. Kobey, Jr. had the intent to deceive plaintiff. Plaintiff, however, has failed to establish that defendant Marilynn J. Kobey had the requisite intent.

8. Silence or omissions regarding a material fact can constitute a false representation under § 523 (a)(2)(A) when there is a duty to disclose. Citibank (South Dakota) N.A. v. Eashai (In re Eashai), 87 F.3d 1082, 1089 (9th Cir. 1996), citing *inter alia*, Restatement (Second) of Torts § 551 (1976); Cooke v. Howarter (In re Howarter), 114 B.R. 682, 684 n. 2 (9th Cir. Bankr. 1990)(cited for the proposition that debtor's silence or concealment of a material fact can create a false impression which constitutes a misrepresentation under §523(a)(2)(A)); Trizna & Lepri v. Malcolm (In re Malcolm), 145 B.R. 259, 263 (Bankr. N.D. Ill. 1992)("[W]hen the circumstances imply a particular set of facts, and one party

knows the facts to be otherwise, that party may have a duty to correct what would otherwise be a false impression").

This fact finder concludes that when requesting increased credit lines and when exceeding established credit spending limits, defendant Cyril Kobey's silence about pending bankruptcies was an omission of a material fact[2] that constituted a false representation. Mrs. Kobey's uncontradicted testimony that she believed her husband's statement that he had informed TSI of the bankruptcies, excuses any duty she might have had to break her silence regarding this issue.

9. The Supreme Court has ruled that creditor's reliance need only be justifiable, not reasonable. Field v. Mans, 516 U.S. 59, 116 S.Ct. 437, 446 (1995), Apte v. Japra, M.D., F.A.CC., Inc. (In re Apte), 96 F.3d 1319, 1322 (9th Cir. 1996). A person is justified in relying on a representation of fact even though one might have learned of its falsity by conducting an investigation. Field, at 444, citing Restatement (Second) of Torts §540 (1976). Although one cannot close one's eyes and blindly rely, mere negligence in failing to discover an intentional misrepresentation is no defense to fraud. Apte at 1322, citing Eashai, 87 F. 3d at 1090-91. Given the parties' long-standing personal relationship, dating back to January of 1997, plaintiff's failure to conduct a credit

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[2]Kobey's extensive business experience in restaurant management since March of 1986 reasonably would have led him to appreciate the materiality of a pending bankruptcy case in making credit decisions. Further, Kobey himself explicitly established the materiality of bankruptcy by testifying he unilaterally decided to inform TSI of his bankruptcy cases. This fact finder is not convinced he actually did so, however. *See* findings of fact 5-7, 9-10, 12 and 14.

investigation, prior to increasing the credit line or allowing it to be exceeded is justifiable.

10. Viewing the totality of the circumstances, through the evidence presented at the bench trial, including judging witness credibility, this fact finder concludes plaintiff has proven by a preponderance of the evidence that defendant Cyril H. Kobey, Jr. made a misrepresentation by fraudulent omission, knowing the omission was of a material fact, with the intent to deceive plaintiff, who justifiably relied and proximately suffered damage as a result.

11. Plaintiff did not establish by a preponderance of the evidence that defendant Marilynn J. Kobey intended to misrepresent a material fact to plaintiff. The wrongful conduct of one spouse cannot be attributed to the innocent spouse for purposes of nondischargeability under §523(a). Tsurukawa v.Nikon Precision, Inc. (In re Tsurukawa), 258 B.R. 192, 196-98 (9th Cir. Bankr. 2001), citing La Trattoria, Inc. v. Lansford (In re Lansford), 822 F.2d 902, 904-05 (9th Cir. 1987).

12. Defendants' marital community will not be liable for this claim unless it is shown to be a community debt. Case v. Maready (In re Maready), 122 B.R. 378, 381 (9th Cir. Bankr. 1991). Whether a creditor holds a community claim is determined by state law. F.D.I.C. v. Soderling (In re Soderling), 998 F.2d 730, 733 (9th Cir. 1993); Maready, at 381, n.2.

13. Arizona law is settled that the community property of both spouses may be liable for an intentional tort committed by one

spouse, where the intent and purpose of the activity leading to commission of the tort was to benefit community interests. Cadwell v. Cadwell, 126 Ariz. 460, 616 P.2d 920, 923 (Ariz. App. 1980). Benefit to the community need not be the primary object or intention. All that is required is that some benefit was intended for the community. *Id.* The uncontradicted testimony of both defendants was that credit purchases were made for the personal benefit of defendants and their children. The court concludes this nondischargeable debt may be collected from the non-exempt property of the marital community of defendants and the personal property of Cyril H. Kobey, Jr. Plaintiff's claim will be discharged in this bankruptcy as a personal liability of Marilynn J. Kobey.

ORDER

1. The Court finds for plaintiff and against defendant Cyril H. Kobey, Jr.

2. The Court finds for defendant Marilynn J. Kobey and against plaintiff. Plaintiff's complaint and cause of action against this defendant will be dismissed with prejudice.

3. Plaintiff will promptly lodge and serve a proposed judgment consistent with these findings and conclusions. Defendants will have seven days from the date of service to file and serve objections to the form of judgment.

Dated this 20th day of November, 2002.

George B. Nielsen, Jr.
United States Bankruptcy Judge

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