

Simons and Gales v. Kolwitz, Adversary No. 08-6067-fra
K Properties, LLC, Case No. 07-62870-fra7

5/27/10

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Unpublished

Debtor Kolwitz, whose bankruptcy case was consolidated with that of his construction company, K Properties, LLC, contracted with the Plaintiffs in 2005 to build a house on property the Plaintiffs had purchased at the Oregon coast. Throughout the history of the project, there were multiple change orders and regulatory delays which put the Defendant behind schedule. A series of events reduced the Defendant's ability to fully fund his operations and progress on the Plaintiffs' project continued to slow. Defendant's cash flow difficulties were exacerbated by the Plaintiffs' failure to fund regular draws for work performed. In October 2007, Plaintiffs terminated the construction contract. Plaintiffs thereafter denied Defendant's request for funds to continue the project and declined to provide funds to seal up the project against the oncoming winter weather.

Plaintiffs filed this adversary proceeding to except their claim for damages from discharge under Code § 523(a)(2). The complaint does not allege any specific misrepresentations made by Defendant - Plaintiffs' principal argument is that Defendant was obligated to disclose his business practices to Plaintiffs at the time they entered into the contract. Specifically, the fact that in order to accommodate the requirements of cash flow, he may at times use money from one project to pay expenses for another project.

After trial, the Court held for Defendant and dismissed the complaint. Plaintiffs failed to present sufficient evidence that the implied misrepresentation was material (evidence was presented that the complained of practice was not uncommon in the industry) or that Defendant's failure to disclose was made with the intent to induce Plaintiffs into entering into the contract. Moreover, where a misrepresentation involves the debtor's "financial condition," §§ 523(a)(2)(A) and (B) require that it be made in writing. The Court ruled that this information directly involved Defendant's financial condition and there was nothing in writing.

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8 UNITED STATES BANKRUPTCY COURT
9 FOR THE DISTRICT OF OREGON

10 In Re:) Bankruptcy Case
11 K PROPERTIES, LLC,) No. 07-62870-fra7
12 _____ Debtor.)
13 GEORGE SIMONS and CARMEN GALES,) Adversary Proceeding
14 Plaintiffs,) No. 08-6067-fra
15 vs.)
16 ROBERT A. KOLWITZ,)
17 _____ Defendant.) MEMORANDUM OPINION

18 I. INTRODUCTION

19 Plaintiffs claim damages arising out of the failure of a
20 construction contract. They allege that the claim arises out of
21 Defendant's fraudulent misconduct, and that the claim should be excepted
22 from discharge under Code §§ 523(a)(2)¹. The matter came on for trial on
23 February 2, 2010. Having carefully considered the testimony, evidence,
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25 ¹ Plaintiffs' complaint also contained claims under Code §§
26 523(a)(4) and (a)(6), but they were eliminated upon entry of an order by
this court on cross-motions for summary judgment.

1 and argument of the parties, I find that the Plaintiffs have not
2 sustained their burden of proof, and that their claims in this adversary
3 proceeding should be dismissed.

4 II. BACKGROUND

5 A. Defendant's Business

6 Robert Kolwitz has been in the construction business since his
7 youth in the 1960's. In 1995, he established himself as a contractor on
8 the Oregon coast, and eventually built a business specializing in the
9 construction of high-end second homes on the central Oregon coast.

10 Eventually Defendant's business enterprise consisted of his
11 construction operation, incorporated as Kolwitz Construction, and his
12 interest in Picture Book Properties. Picture Book was an LLC consisting
13 of Defendant and one Ellyn Bye. Using funds supplied by Bye and proceeds
14 of prior sales, Picture Book acquired undeveloped residential properties,
15 primarily in the Lincoln County, Oregon, area. The business plan was
16 that Picture Book would then sell properties to people interested in
17 building homes. The homes would be built by Kolwitz Construction.

18 Over time, Kolwitz invested a considerable amount of his cash
19 in the acquisition of property on speculation through Picture Book. As
20 this practice continued, Kolwitz became heavily dependant on sales by
21 Picture Book to maintain the liquidity needed to continue his
22 construction business. In addition, the construction business was
23 heavily leveraged by use of "leased" labor. Rather than pay for the
24 labor at the time the work was done, Kolwitz relied on an extensive line

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1 of credit from the employment agency, thus freeing up cash for other
2 purposes.²

3 Defendant managed to keep his business going by continued
4 construction and sales, often resorting to "robbing Peter to pay Paul,"
5 that is, applying immediately available funds to the most immediate
6 demands of creditors, even if the funds and the demands being met were
7 attributable to different contracts or projects. Both Plaintiff, George
8 Simons, a businessman, and Plaintiffs' expert witness acknowledged that
9 this sort of practice, while perhaps not advisable, is not unheard of in
10 the construction business.

11 The shaky edifice of Defendant's business came crashing down by
12 the end of 2006. The Defendant had placed several parcels acquired by
13 Picture Book in his own name. Ostensibly, this was done in order to
14 facilitate construction lending relating to those properties: the
15 lenders insisted that the borrower be an individual, and not a
16 corporation. This apparently was not Ms. Bye's understanding, and, by
17 December of 2006, she had determined to dissolve Picture Book. In the
18 ensuing dispute, considerable pressure was applied, and Defendant
19 eventually gave in, signing away his interest in most of Picture Book's
20 assets. This loss deprived him of the capital he needed to continue his
21 business. A second blow came several months later when the principal of
22 Coastal Employment passed away. Her successors declined to extend
23 further credit to the Defendant. It soon became impossible for the
24 Defendant to continue, and his business, K Properties, filed for relief

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26 ² The claim of the employment agency, Coastal Employment Services,
is for \$907,225.

1 under Chapter 11 of the Bankruptcy Code on October 12, 2007, followed by
2 Defendant's personal bankruptcy on November 16. The cases were
3 consolidated and converted to a case under Chapter 7 on the following
4 January 30.

5 B. Simons' Contract

6 On July 20, 2005, Plaintiffs and Defendant entered into an
7 agreement for the construction by Defendant of a home on property
8 Plaintiffs had just acquired from Picture Book. The contract called for
9 the construction of the home at a fixed price, with additional changes on
10 a cost plus basis. Throughout the short history of the project, there
11 were multiple change orders and regulatory delays which put Defendant
12 considerably behind schedule. (In the contract he had promised to
13 complete the work within 12 months.)

14 In early 2007, Countrywide Home Mortgages, the construction
15 lender, gave notice that it was terminating the loan due to slow
16 progress. This forced the Plaintiffs to arrange for new financing
17 through a different lender. Eventually three different lenders were
18 involved in the project.³

19 As Defendant's business troubles grew, progress on the project
20 continued to slow. Defendant's cash flow difficulties were exacerbated
21 by the Plaintiffs' failure to fund regular draws for work performed.
22 Concerned with Defendant's slow performance, perceived shoddy
23 workmanship, and - no doubt - Defendant's Chapter 11 bankruptcy,
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25 ³ It does not appear that the change in lenders had anything to do
26 with the Defendant. The loan officer at each lender was the same person,
an acquaintance of Plaintiffs.

1 Plaintiff terminated the contract in October 2007. Defendant, through a
2 business consultant engaged to assist him in the reorganization, asked
3 for funds to continue the project, but the request was denied. Moreover,
4 Plaintiff declined to provide funding to seal up the project against the
5 oncoming winter weather. The last work done on the project by Defendant
6 was on October 17.

7 III. ANALYSIS

8 A. Code § 523(a)(2) excepts from discharge any debt

9 (2) for money, property, services or an extension
10 renewal or refinancing of credit, to the extent
11 obtained, --

12 (A) false pretenses, a false representation, or actual
13 fraud, other than a statement respecting the debtor's
14 or an insider's financial condition;

15 In an action to except a claim from discharge under § 523, the
16 Plaintiff has the burden of proving, by a preponderance of the evidence,
17 each of the elements of the claim. Grogan v. Garner, 498 U.S. 279, 111
18 S.Ct. 654 (1991).

19 In order to prove fraud under § 523(a)(2)(A), a creditor must
20 prove by a preponderance of the evidence the following five elements: (1)
21 the debtor made a material representation, (2) with knowledge of its
22 falsity, (3) with the intent to deceive, (4) on which the creditor
23 justifiably relied, and (5) due to which the creditor sustained loss or
24 damage. In re Kirsh, 973 F.2d 1454, 1457 (9th Cir. 1992).

25 The Plaintiffs do not point to any particular misrepresentation
26 made to them by the Defendant. It is true that the Defendant promised
27 that the construction work would be done within a specified period of
28 time. However, there is no evidence that the Defendant did not intend to

1 perform at the time he made the promise, and there is considerable
2 evidence of intervening events which the Defendant could not have
3 anticipated.

4 Plaintiffs' principal argument is that Defendant was obligated
5 to disclose his business practices to Plaintiffs at the time the contract
6 was entered into. Mr. Simons testified that had he known of Defendant's
7 management practices he would not have entered into the contract. In
8 other words, Plaintiff complains not of representations made to him, but
9 of information not disclosed.

10 Under the Code, "false pretenses" contemplates circumstances in
11 which a course of conduct - as contrasted with an explicit representation
12 - is intended to mislead. It includes an implied misrepresentation or
13 conduct intended to create or foster a false impression. In re Cole, 164
14 B.R. 951 (Bankr. N.D. Ohio 1993). Moreover, fraud or false pretenses may
15 be discerned where the debtor has failed to disclose facts material to a
16 lender in order to induce the lender to grant credit. In re Roberti, 183
17 B.R. 991 (Bankr. D. Conn. 1995) (Deliberate nondisclosure of a material
18 fact may amount to a "false pretense" under § 523(a)(2)(A)).

19 Discharge has been withheld in cases where the defendant acted
20 consciously to mislead the plaintiff by creating a false impression or by
21 withholding crucial information. That is not the case here: there is no
22 evidence that Defendant concealed any information for the purpose of
23 deceiving the Plaintiff. The mere fact that the Defendant had a
24 precarious - not to say reckless - business plan does not by itself give
25 rise to a claim for exception to discharge. Nor does the fact that the
26 Defendant entered into a contract while experiencing financial

1 difficulties, absent a showing that he knew at the time that he would be
2 unable to perform. There is no evidence to that effect in this case.
3 Moreover, the information concerning business practices the Plaintiffs
4 now assert should have been disclosed, to the extent it bears on
5 Defendant's financial condition, is only actionable if reduced to
6 writing. Code §523(a) (2) (A) specifically excludes a statement respecting
7 a debtor's or insider's financial condition.

8 Where a statement involves a debtor's or insider's financial
9 condition, Code § 523(a) (2) (B) excepts from discharge a debt to the
10 extent obtained by:

- 11 (B) use of a statement in writing -
12 (i) that is materially false;
13 (ii) respecting the debtor's or an insider's
14 financial condition;
15 (iii) on which the creditor to whom the debtor
is liable for such money, property, services
or credit reasonably relied; and
16 (iv) that the debtor made or published with
intent to deceive;

17 There are two schools of thought regarding which statements
18 come within the parameters of a "debtor's financial condition" for
19 purposes of § 523(a) (2). One holds that a statement of financial
20 condition denotes either a representation of a person's overall "net
21 worth" or a person's overall ability to generate net income, and
22 generally connotes traditional financial statements. See e.g. Jokay
23 Company v. Merdado (In re Mercado), 144 B.R. 879, 885 (Bankr. C.D.Cal.
24 1992). Other courts have adopted a more expansive definition of
25 "financial condition" and hold that financial condition involves more
26 than statements of profit and loss, balance sheet, and cash flow. See
e.e. Engler v. Van Steinburg (In re Steinburg), 744 F.2d 1060 (4th Cir.

1 1984) (whether debtor's assets are encumbered is statement of financial
2 condition); In re Barrack, 201 B.R. 985, 987-88 (Bankr. S.D.Cal.
3 1996) (oral misrepresentations about debtor's ownership of home, monthly
4 income, value of assets, and ability to service a debt concern financial
5 condition). I adopt the more expansive formulation of "financial
6 condition" and find that Defendant's practice of using funds from one
7 project to pay expenses related to another project when required directly
8 involves Defendant's financial condition; any representation made thereof
9 must be in writing in order to come under the rubric of § 523(a)(2). The
10 construction contract between Plaintiffs and Defendant does not contain a
11 representation regarding the earmarking of funds, nor was any other
12 evidence presented at trial of such a representation, written or
13 otherwise, made prior to the time that the parties entered into their
14 agreement.

15 Even if I were to hold that the alleged implied
16 misrepresentation regarding the Defendant's practice came within the
17 ambit of § 523(a)(2)(A), Plaintiffs' claim requires the Court to find
18 that the Defendant had a duty to disclose his payment practice (i.e. that
19 it was material to the transaction) and that his failure to so disclose
20 was made with the intent to deceive Plaintiffs into entering into the
21 transaction. Based on the evidence presented at trial, I cannot so find.
22 Both the Defendant and the Plaintiffs' expert witness testified that the
23 practice complained of is not uncommon in the construction business. As
24 to Defendant's intent to deceive, Plaintiffs' have submitted insufficient
25 evidence to meet their burden.

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1 IV. CONCLUSION

2 Plaintiffs have not provided sufficient evidence to meet their
3 burden of proving damages based on state-law fraud⁴, which essentially
4 mirrors the definition in § 523(a)(2), and nondischargeability of their
5 debt under Code § 523(a)(2). Accordingly, judgment will be entered for
6 Defendant. Counsel for Defendant should submit a form of judgment
7 consistent with this Memorandum Opinion.

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10 FRANK R. ALLEY, III
11 Bankruptcy Judge
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22 ⁴ In order to succeed on a claim for fraud under Oregon law, a party
23 must prove the following elements: (1) a representation; (2) its falsity;
24 (3) its materiality; (4) the speaker's knowledge of its falsity or
25 ignorance of its truth; (5) the speaker's intent that it should be acted
26 on by the person and in the manner reasonably contemplated; (6) the
hearer's ignorance of its falsity; (7) the hearer's reliance on its truth;
(8) the hearer's right to rely thereon; (9) and the hearer's consequent
and proximate injury. Merten v. Portland General Electric Co., 234
Or.App. 407, 416, 228 P.3d 623 (2010) (internal citation omitted).