UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
WESTERN DIVISION

In Re:	)	Case No. 01-32853
	)	
Robert B. Keller,	)	Chapter 7
	)	
Debtor.	)	Adv. Pro. No. 01-3176
	)	
H2S Limited, dba H2S Factor and Finance,	)	Hon. Mary Ann Whipple
	)	
Plaintiff,	)	
	)	
v.	)	
	)	
Robert B. Keller,	)	
	)	
Defendant.	)	

MEMORANDUM OF DECISION

This adversary proceeding is before the court for decision after a trial on the merits of H2S Limited's ("H2S") First Amended Complaint to Determine Dischargeability of Debt against Defendant/Debtor Robert B. Keller ("Keller"). H2S claims that Keller owes it a debt of $91,044.06, which it alleges should be excepted from Keller's Chapter 7 discharge under 11 U.S.C. §§ 523(a)(2)(A) or (a)(6), and a judgment entered for the amount of the debt, plus punitive damages, interest and attorney's fees.

The court has jurisdiction over Keller's underlying Chapter 7 bankruptcy case and this adversary proceeding under 28 U.S.C. § 1334(a) and the general order of reference to bankruptcy courts in this district. As an action objecting to the discharge of a debt, this is a core proceeding that this court may hear and determine under 28 U.S.C. §157(b)(2)(A). This memorandum of decision

constitutes the court's findings of fact and conclusions of law pursuant to Fed.R.Civ.P. 52(a), made applicable to this adversary proceeding by Fed.R.Bankr.P. 7052.

Regardless of whether specifically referred to in this memorandum of decision, the court has examined all of the evidence, weighed the credibility of the witnesses and reviewed the entire record of the case. For the reasons and based on the authorities set forth below, the court finds that Keller owes H2S a debt of $85,581.42, which is nondischargeable in Keller's Chapter 7 bankruptcy case under 11 U.S.C. § 523(a)(2)(A).

I. Facts and Procedural Background:

A. The Parties and Witnesses

H2S is an Ohio limited liability company engaged in the business of "factoring" accounts receivable. Mark Smigelski ("Smigelski"), one of the four principals of H2S, testified at trial, as did Kathy Thomas ("Thomas"), H2S's full-time administrative assistant since February, 1997. H2S is not a full time business for Smigelski and the other principals of the company. He also works as a financial consultant with a Toledo insurance agency and financial consulting firm. Smigelski testified that H2S's business as a "factor" involved purchasing at a discount select accounts receivable of its client businesses, and then collecting in due course the total amount of the receivable purchased from its client. Typically, H2S purchases an account receivable at 94% of its face value, with 1% discounted or refunded if payment on the account is received within thirty days.

Smigelski (and witness Thomas Sheehan) testified that, because factoring is an expensive source of cash, clients usually turn to factoring accounts receivable only when they have exhausted a line of credit or are looking for alternative financing. Smigelski emphatically testified that H2S neither makes loans in the conventional sense nor functions as a collector. In fact, he said,

H2S's own loan agreement with its lender prohibited it from making loans. The company routine in taking on new factoring clients involved shared decision-making of all four H2S principals. Typically, they would meet with the owner of the company, learn the company's history, examine its relationship with its traditional lender, if any, analyze liens, do their homework on the receivables being purchased and then decide as a group to proceed or not. H2S typically established a purchase ceiling with its clients. Thomas was then responsible for running the office on a daily basis, keeping the books and handling the administrative functions of H2S's operations. The four principals of the business followed up with monthly meetings "to stay on top" of things. [*See* Def. Ex. MM: selected H2S monthly meeting minutes].

Smigelski's understanding was that, once purchased from its clients, H2S then owned the accounts receivable. In terms of actual collection mechanics, however, there were two alternatives used with its clients. Some account debtors were directed to send the amounts owed on a purchased receivable directly to an H2S lockbox. Others clients were still permitted to collect from the account debtors the amount due, even though the receivable had been sold to H2S, and then remit the collected amount to H2S.

One of H2S's factoring clients was W.E. Baker, Inc. ("Baker"). Baker was a small steel fabricating company located in Swanton, Ohio. It was a family business started by Keller's grandfather in 1932. Its business involved custom fabrication work for glass engineering companies in the Toledo area, and material handling racking for companies such as Cooper Tire and other automotive suppliers. In the 1980s, Baker's sales were in the $600,000 to $700,00 annual range, growing to approximately $1.2 million in 1997. [Tr. 35].

At the commencement of its relationship with H2S in 1996, the company stock was owned by a trust. [Pl. Ex. 4]. At some point in 1998, Keller acquired all of the stock of the company. [Tr. 4]. At all times relevant to this case, Keller was also the president of Baker, as well as the secretary and sole director. [Pl. Ex. 3, 4]. Keller's duties involved all aspects of running Baker's operations, including sole responsibility for making financial decisions. This included deciding what bills should be paid and when, signing checks, and finding operating capital for ongoing business operations. [Tr. 4-5]. Keller was assisted by his office manager Janet Vaughan, whose duties as a 19 year employee of the company included handling the phones, correspondence, purchasing material, and billing customers. As to the payment of company bills, she routinely ran a list to be reviewed by Keller, but did not make any of these kinds of decisions herself.

Of significance to this case, Smigelski had a relationship with Baker and Keller as far back as 1975, pre-dating the H2S transactions with Baker. Smigelski worked at Baker during high school and college until 1981, when he graduated from Bowling Green State University and became a financial consultant with his current employer. He had interviewed with Keller for his job at Baker, and worked for Keller and Keller's dad in the company. Smigelski characterized Baker and Keller as great to work for, with he and Keller maintaining a personal relationship until the Baker-H2S business relationship foundered over the events of this lawsuit. Smigelski and other colleagues of his also sold to Baker, Keller and Keller's family, and serviced, various insurance and financial service products.

Through the mid to late 90s, Baker was struggling financially, with its difficulties accelerating in 1999. Working capital was a constant problem. The relationship between Smigelski,

H2S, Baker and Keller, and Baker's ongoing financial struggles, led to the introduction of another cross-connected participant in the events in issue, one whose actions at various points are the subject of conflicting testimony among the witnesses. Through his own consulting company, Thomas Sheehan ("Sheehan") works as a financial advisor to businesses. H2S was a Sheehan client in 1995 and 1996. Due to unexpected company growth, H2S also had issues with its current bankers. For H2S, Sheehan helped organize the financial structure of the company and establish procedures and documents [*see* Def. Ex. F-AA] for its business of factoring accounts receivable. He also worked with all H2S clients in terms of ongoing administrative issues in 1995 and 1996.

Baker was also a client of Sheehan's. Sheehan worked as a consultant to Baker, paid on an hourly basis, from 1996 through the closing of the company in August, 2000. He was introduced to Baker by the principals of H2S [Tr. 41], who thought that Sheehan could help Baker. As factoring is typically only a viable short term arrangement, because of its high cost, Sheehan's initial role with Baker was to address the weakness in its balance sheet and working capital position by finding new, longer term, more cost-effective financing for the company. He initially succeeded, negotiating a lending relationship for Baker with Key Bank [Tr. 42] that commenced on May 29, 1997. Once that relationship was in place, Sheehan continued to consult with Baker on financial matters, including assisting in compliance with its Key Bank loan covenants.

Key Bank cut off Baker's line of credit sometime in mid-1999, as the company was losing money and encountering serious cash flow problems. Sheehan then began exploring avenues for sale of Baker to generate additional equity and fund ongoing operations. He pursued a transaction with a company he was familiar with called the Delp Company, going so far as to form a separate

limited liability company in the summer of 1999, apparently to buy Baker's highly depreciated, fixed assets and then lease them back to the Baker. The Delp Company transaction never closed, however, for reasons that are not known on the record.

B. The 1996-1997 Transactions Between H2S and Baker

H2S began factoring certain of Baker's accounts receivable in 1996. Notwithstanding the familiarity between Smigelski, Baker and Keller, H2S was introduced to Baker by Les Thornton, an accountant who was working for Baker at that time. While Keller was familiar with Smigelski and one of H2S's other principals, Dick Herrick (also a financial services firm colleague of Smigelski's, who also serviced Baker and Keller business), he was not aware of H2S or its business. [Tr. 36-38]. At the same time, Thornton was also trying to put together a conventional banking package for Baker. [Tr. 38].

The H2S/Baker factoring relationship started as early as January, 1996. [Def. Ex. F, G, which appear to be same transaction]. The agreed ceiling was $100,000.00. There appears to be at least one purchase of receivables in January, 1996, [*Id*], with documentation signed by Thornton, and then a larger number of purchases starting again in November, 1996, and through March, 1997. [Def. Ex. H- HH]. The latest documentation in the record during this time frame is for purchases made on March 21, 1997. [Def. Ex. HH]. The latter transaction appears to have caused the $100,000 ceiling for Baker to have been exceeded. [Def. Ex. BB and HH]. Thornton handled some of the transactions [Def. Ex. F, G, L, N, O], Keller handled some of the transactions [Def. Ex. S, T, V, W, X,Y, Z, FF and GG], and Sheehan was clearly involved in at least some of the transactions [Def. Ex.H, BB, CC], apparently but not completely clearly on behalf of H2S. While he testified that he

worked with H2S in 1995 and 1996, one of the transactions upon which he appeared to be working for H2S occurred in March, 1997. [Def. Ex. BB].

For the initial transaction in January, 1996, Baker, through Thornton, executed a one page document called "Accounts Receivable to be Purchased." [Def. Ex. F]. It stated as follows:

> The attached Schedule A is a list of accounts receivable we wish for you to purchase. We have attached a copy of the invoice (unaltered from the original), a copy of the original purchase order and a copy of the shipping documents/instructions. By requesting this purchase, we confirm that we are in compliance with the terms and conditions of the Security Agreement dated ___________[sic] as well as any other document involving this relationship. To the best of our knowledge, all customers listed are solvent and full payment is expected. Unless otherwise noted, we have notified all debtors to remit payment to P.O. Box 2342, Toledo, Ohio 43603.

Thereafter followed a worksheet showing the total of accounts purchased, the 6% fee amount and the net cash proceeds to Baker, and Thornton's signature and certification that the information provided was true and correct. There was, however, no separate security agreement at that time.

The lack of a security agreement changed in the fall of 1996. Each party has submitted and had admitted as evidence a document called Security Agreement. [Def. Ex. D and Pl. Ex. 1]. Keller admits that he signed the Security Agreement, as President of Baker, on September 24, 1996. The documents are the same, except that the version admitted as Plaintiff's Exhibit 1 has one provision on page 2 crossed out and initialed by Keller, while that provision is not crossed out on the version admitted as Defendant's Exhibit D. Neither version has ever been signed by H2S, and Smigelski testified that he has never seen one signed by H2S. The court finds that H2S never signed the Security Agreement, which is of significance because of the final paragraph thereof stating that "EFFECTIVE: This Agreement becomes effective when it is accepted and executed by the authorized officers of H2S." [Pl. Ex. 1, ¶ 67; Def. Ex. D, ¶ 67]. Smigelski testified that this was a routine H2S

agreement, from which the court infers that it was drafted by H2S. Although it is not in evidence, Baker apparently also executed a UCC-1 financing statement in connection with the agreement, as there was a release of one effected by H2S in connection with the Key Bank transaction. [Def. Ex. JJ].

Some of the other potentially relevant provisions of the document are as follows, with the CLIENT being Baker:

1. ¶ 10. CLIENT warrants and/or covenants that:
   - ¶ 12. CLIENT 's business is solvent.
   - ¶ 14. CLIENT is, at the time of purchase by H2S, the lawful owner of and has good and undisputed title to the accounts purchased by H2S.
   - ¶ 17. CLIENT will not, under any circumstances or in any manner whatsoever, interfere with any of H2S's rights under this Agreement.
   - ¶ 21. CLIENT will not transfer, pledge or give security interest in any of its accounts to any other party.
   - ¶ 23. CLIENT will not permit any lien, security interest or encumbrance to be created upon its fixtures, inventory or property except without prior written consent from H2S.
2. ¶27. Security interest in all accounts receivable given to H2S.
3. ¶30. ASSIGNMENT: CLIENT shall from time to time at CLIENT's option sell, transfer, and assign accounts to H2S and said accounts shall be identified by separate and subsequent written assignments on a form to be provided to CLIENT by H2S.
4. ¶32. DISCOUNT: H2S agrees to but acceptable accounts from CLIENT at a discount (fee) of six percent (6%) from the face value of each account.
5. ¶35. REBATES: Left blank on document.
6. ¶36. REQUIRED FORMS: When CLIENT offers a schedule of Accounts to H2S for sale, H2S shall receive ...an original invoice [plus other documents].
7. ¶¶37 and 38. NO RECOURSE: [against CLIENT except for certain enumerated circumstances including breach of warranties or non-payment of invoice within 60 days from the date of purchase by H2S].
8. ¶ 45. SOLE PROPERTY: Once H2S has purchased an account, the payment from customer as to that account is the sole property of H2S. Any interference by CLIENT with this payment will result in civil and/or criminal liability.

9. ¶ 46. HOLD IN TRUST: CLIENT will hold in trust and safekeeping, as the property of H2S, and immediately turn over to H2S the identical check or other form of payment received by CLIENT, whenever any payment on an account purchased by H2S comes into CLIENT'S possession. ***
10. ¶53. LEGAL FEES: the losing party will pay any and all legal expenses and reasonable attorney's fees that the prevailing party may incur as a result of either CLIENT or H2S enforcing this Agreement against the other.
11. ¶59. TERMINATION: This Agreement shall continue in full force and effect until terminated by either party.
12. ¶63. WRITTEN WAIVER: H2S may not waive its rights and remedies unless the Waiver is in writing and signed by H2S.
13. ¶64. Ohio law governs the Agreement.

In addition to the Security Agreement, Keller also signed in his own stead a document called Continuing Guaranty & Waiver. [Pl. Ex. 2; Def. Ex. E]. The document purports to be a personal guaranty of indebtedness of Baker to H2S. But the preamble states that "reference is made to the Security Agreement (herein "AGREEMENT") dated November 11, 1996 [handwritten] and entered into between W.E. Baker, Inc. [handwritten] (Herein "Company") and H2S (herein "H2S"). For valuable consideration and to induce H2S to enter into AGREEMENT, the undersigned agrees as follows:..." The date Keller signed the Security Agreement, never signed by H2S, was September 24, 1996. That date is well before the date of the personal guaranty document, which was purportedly signed to induce H2S to enter into an agreement earlier in time. Smigelski admitted that, as far as he was aware, there never was any Security Agreement dated November 11, 1996.

After Baker signed the Security Agreement, H2S purchases of receivables from Baker accelerated. Smigelski testified that the routine was a purchase for 94% of the invoice amount, as set forth in the Security Agreement, with a 1% discount if paid in 30 days, which provision was not in the Security Agreement and instead was left blank. [Pl. Ex.1, ¶ 34]. The H2S purchases in late 1996

through March, 1997, were separately evidenced on additional assignment documents, as required by the Security Agreement. [Pl. Ex. 1, ¶30]. Most of them had the same form as for the January, 1996, purchases, described above, signed by Keller as President of Baker and submitted to H2S. [Def. Ex. L-M, N, O, S(slightly different form, with no reference to the Security Agreement), T-U, V, X, Y, Z-AA, FF, GG]. On most of them, the spot where the date of the Security Agreement was to be filled in was left blank. Some of them, however, did have the date of the Security Agreement (9/24/96) typed in. [*See, e.g.* Def. Ex. FF, GG].

Smigelski testified on cross-examination that the procedure the parties followed on the 1996 and 1997 factoring transactions permitted Baker's customers, such as Cooper Tire, to send their payments directly to Baker. The account debtors on the purchased receivables were never required to pay H2S directly. Nor did H2S ever require Baker to have the check actually received by Baker to be brought to H2S. Instead, H2S always allowed Baker to deposit the payments in its own accounts, and then expected payment from Baker "immediately" after payment by its customer. There was no amplification as to what "immediately" meant by any witness. Smigelski admitted that no segregation of the funds Baker received in payment of factored invoices was ever required. Although it did sometimes use a lockbox arrangement with its clients, it never had one with Baker. [Tr. 40]. Baker routinely paid H2S with Baker checks. [Tr. 39-40].

Indeed, most of the parties' course of dealing on the late 1996 and 1997 factoring transactions conflicted with the written provisions of the Security Agreement document, as Baker was never required to turnover the exact form of payment, segregate it or otherwise hold it in trust. Notwithstanding the departure in the course of dealing from the written terms of the purported

Security Agreement, Keller repeatedly testified that he understood that when H2S purchased accounts receivable from Baker, he understood that H2S became the owner of the receivable. [Tr. 8-9,10-11]. He also understood that these transactions were occurring pursuant to terms of the Security Agreement.

Initially, Baker was "immediately" making payments to H2S after receipt of payment from its customers. [Tr. At 40]. But in 1997, Keller admitted, payments became "a little more tardy."

By the time of the closing of the Key Bank loan transaction in May, 1997, [Pl. Ex. 20,23], nearly 2 months after the last factoring transaction of record in 1997, H2S was still owed money close to the $100,000 factoring limit. In connection with the Key Bank closing, H2S was asked to release its filed financing statement(s) [Tr. 42; Def. Ex JJ]. In exchange, H2S was paid off all the money it was owed in a lump sum, with a Key Bank cashiers check in the amount of $98,744.95. [Def. Ex. II; Tr. 42]. Bill Martin, one of Smigelski's partners, not Smigelski, handled the release and payment transactions in connection with the Key Bank closing. Nobody from H2S attended the closing itself.

The record shows that Key Bank and H2S entered into conventional lending transactions, including broad form security agreements with a security interest in all of Baker's assets, including in its accounts receivable. [Tr. 12-13, Pl. Ex. 20-23]. These agreements warranted that Baker was the owner of the collateral, and that it would at all times remain free of other liens, interests or encumbrances. Key Bank's security interest was perfected with the filing on June 11, 1997, of a financing statement in the Fulton County, Ohio recorder's office, which Keller signed in his capacity as President of Baker. [Pl. Ex. 23]. Although Key Bank terminated Baker's line of credit

sometime in 1999, the security interest and financing statement remained of record though the closure of Baker's business in August, 2000 [Tr. 13-14], when all assets were sold at the behest of and the proceeds paid to Key Bank [Pl. Ex. 18].

Smigelski did not know what Key Bank did after the H2S release about a UCC-1 financing statement, although he was aware at the general time of the closing that Key Bank wanted a security interest in all of Baker's assets and a release from H2S. And after that, Smigelski did not follow Baker's business situation. After the outstanding 1997 factoring transactions were paid off, both Smigelski and Keller testified that neither did anything to "terminate" the Security Agreement, or the personal guaranty. But the fact is that the parties did not engage in any further factoring transactions for the balance of 1997, during all of 1998, and during 1999 until May, 1999, a period of almost two years. [Tr. 15, 42-43].

C. The 1999 Transactions Between H2S and Baker

The factoring transactions that are the basis for this lawsuit occurred in 1999, and their genesis is the subject of disputed testimony. There were two sets of H2S purchases of Baker customer invoices in 1999: one set of five invoices totaling $56,671.83 purchased on May 17, 1999, for $53,271.52 [Def. Ex. PP] and one set of thirteen invoices totaling $91,044.06, purchased almost three months later on August 11, 1999, for $85, 581.42 [Pl. Ex. 8; Def. Ex. PP]. H2S never received payment for this last set of invoices.

Baker's financial troubles were worsening by May, 1999. There is very little testimony in the record about the May, 1999, transactions. Key Bank had terminated Baker's line of credit sometime in 1999, apparently before May, and Sheehan was working frantically to close the

transaction for the sale of Baker's assets to the Delp Company. [Tr. 22-23]. Smigelski testified that he did not initially remember that a factoring transaction had occurred in May, 1999, does not recall how it arose and does not know what the payment arrangement was in May, 1999. Thomas testified that Smigelski told her in May, 1999, that Bob Keller "would be factoring invoices." Smigelski does, however, recall the August, 1999, transaction and testified that he negotiated it directly with Keller.

Keller has a different recollection. His testimony is that he was by then putting daily pressure on Sheehan to get the Delp transaction closed, because of Baker's serious cash flow problems. Initially, Keller avoided answering directly the question asked by his lawyer "How did W.E. Baker obtain funding from H2S in May of 1999?" [Tr. 44-45]. Later, Keller testified that he recalled that "I got a phone call from Mr. Sheehan, saying that Mark and Dick, or H2S, had agreed to factor some invoices to take the pressure off until we could get the loan closed." [Tr. 58]. At that time, he testified, it was anticipated that the Delp transaction would close in July "and the factoring with H2S was a gap-type measure to get us through to the closing." [Tr. 45]. Later, he testified that "Tom Sheehan negotiated the loan in May." [Tr. 19, 65, 66]. On the one hand, Keller acknowledges that the transaction involved "factoring" and the sale of invoices to H2S, as before. [Tr. 15, 23,67]. On the other hand, however, he repeatedly insisted that Baker was free to use the payments on the factored invoices from its customers as it chose, with H2S to be repaid out of the proceeds of the sale of the business. [Tr. 19, 21, 22, 67]. These were the terms that Keller insisted Sheehan had negotiated with H2S. The record shows that Baker's customers had paid all of the invoices factored in May, 1999, by July 12, 1999, with one paid as early as June 14, 1999. [Def. Ex. UU].

Sheehan, on the other hand, testified that Keller suggested going back to H2S for cash

to be generated through factoring. Sheehan testified that he did not dissuade Keller, as he thought H2S might help. Sheehan admits that he discussed with Keller the permissibility of factoring given the Key Bank security arrangements, and believed (probably incorrectly) that it would not be problematical from the Key Bank perspective to factor $40,000-$50,000 of receivables because there would still be sufficient collateral to otherwise cover the Key Bank debt. He insisted that he did not, however, contact H2S. He assumed that Keller did, because Sheehan knew the factoring occurred. Sheehan was adamant in his testimony that he did not negotiate any transaction between Baker, Keller and H2S in any way, either in May, 1999, or in August, 1999.

There were no new documents signed in connection with the May transaction; no security agreement or guaranty and, most significantly, no assignment/individual transaction purchase documents. The amount advanced by H2S to Baker was 94% of the invoices purchased, the same as with the 1996 and 1997 transactions. [Def. Ex. PP]. Again, there was no direction from H2S to Baker's customers to pay H2S directly, and as before, no requirement that the checks received be turned over to H2S. Keller insists that the only difference from 1996-1997 was that Baker had no obligation to turn over the proceeds of the receivables after receipt.

As to the May transaction, the court the doubts the accuracy of Keller's recollection. Sheehan's focus was on doing the Delp transaction, while Keller's focus was on running the day to day business and making payroll. Sheehan and Keller clearly discussed with one another factoring with H2S; both men agree on that point. Given the nature of his duties for Baker and his prior relationship with Smigelski, the court finds that it was more probable than not that it was Keller who initiated the May transaction with H2S on behalf of Baker, not Sheehan. It is clearer to the court that

Keller negotiated the August, 1999, transaction, from which the court infers that it is likely that he also negotiated the May transaction with H2S. Sheehan was credibly adamant that he did not negotiate either transaction, and as will be shown below, Keller's recollection about the August, 1999, transaction is, at best, vague. Keller's involvement in both transactions, or not, is a fact of particular significance to the § 523(a)(2)(A) claim, because if he was not directly involved, then he obviously cannot have made any nondischargeable, material misrepresentations to H2S.

Whoever negotiated it on behalf of Baker, the May transaction was clearly a sale of invoices. Keller admits that.[See Def. Ex. PP]. The court finds that Keller and Sheehan undoubtedly both intended that the factoring be a stop gap measure to get Baker to the Delp closing, hoped to occur in July, and that was undoubtedly a fact advanced to H2S as a reason to resume the expensive, short term financing inherent in factoring. Nevertheless the court cannot find from the evidence that H2S agreed to that as a term or condition of the transaction.

H2S functioned as a factor of accounts receivable, not a lender. Smigelski's testimony was adamant and credible on that point. H2S's documentation practices were sloppy at best, and its control procedures as to the Baker transactions lax. But it is wholly incredible on this record that Smigelski or anybody else at H2S would have agreed that Baker had no obligation to pay over to H2S the receipts from its customers "immediately" after payment, instead looking to a closing for an uncertain transaction at an uncertain time to be repaid. Further, Keller testified that the August transaction was just a continuation of the May transaction. However, thereafter, when H2O was not paid by October,1999, Thomas began calling Vaughan to find out about the status of invoices, being told variously that some customers had already paid factored invoices and others were paying slowly.

She was not told that she was asking irrelevant questions. Thomas also began sending Baker statements in November, 1999, demanding payment of a monthly "service fee" on old accounts receivable [Pl. Ex. 9-16], to which there was no contest ever advanced from Keller or anybody else at Baker that the funds were not due or that the invoices were not factored. In a fax sent to Sheehan by Keller on September 28, 1999, Keller acknowledged at that time that Baker was holding "their [H2S's] invoices," so that he doubted H2S would do any more factoring. The contemporaneous actions of both parties are consistent with a sale of invoices, to be repaid upon customer payment, not an open ended transaction for repayment upon a tentative sale of company assets.

The Delp transaction did not close as hoped in July, 1999. In August, 1999, Baker's cash flow problems persisted. All of the May invoices had actually been paid [Pl. Ex. 24], but Baker had not in turn paid anything to H2S on the invoices. At that point, Keller hoped that the Delp transaction would close in September. [Tr. 46]. Again, Baker turned to H2S to factor invoices.

Smigelski testified that he directly negotiated the August transaction with Keller, meeting him for lunch at which Keller raised the subject. His recollection is further that Keller had asked for the meeting, which is consistent with the continuing financial difficulties Baker was encountering.

Keller's initial belief was that Sheehan had also negotiated the August transaction, which Sheehan again denied adamantly. Later, however, Keller admitted that he had some recollection of meeting with Smigelski for lunch. The court finds both Smigelski's and Sheehan's testimony credible on this point, particularly given Keller's admitted growing recollection of a meeting with Smigelski. [Tr.65- 66]. That Sheehan was not involved in discussions with H2S in

August is shown by the aforementioned fax Keller sent to Sheehan on September 28, 1999. [Pl. Ex. 19]. The fax says "Tom, I can solve all of my immediate problems if we can discount the following invoices. I don't believe I can call H2S since we are already holding some of their invoices. Do you know anyone else that can help us? This would need to happen ASAP Thanks Bob." If Sheehan had negotiated the August transaction, Keller would not have needed to tell him that Keller could not call H2S because Baker was already holding some of "their invoices."

Smigelski testified that, after some small talk, Keller requested that H2S factor additional accounts receivable in a larger amount. He further admits that Keller told him somebody was interested in buying the business, and that Keller was "trying to bridge the cash flow gap" between then and when the business was purchased. One of the main clients discussed was Cooper Tire. Smigelski said and the court finds that there was no mention of Key Bank, and that he had no knowledge regarding any Key Bank encumbrance of the receivables. He and Keller agreed on a purchase for 94% of face value, with a 1% discount if paid in 30 days. Smigelski testified that, since the invoices had already been sent, Keller would again collect them and pay H2S when he collected. The time frame required for the purchase was immediate. According to Smigelski, notwithstanding the discussion about the need to bridge the gap until sale, at no time during the conversation was the transaction characterized as anything other than a sale of Baker accounts receivable.

Somebody called Thomas to tell her to get in touch with Baker to effect the sale, at which time it was also determined that the May invoices were still outstanding. H2S required that they be paid off. Baker faxed the invoices to Thomas. [Pl. Ex. 6]. Thomas went out and picked up Baker's check for the May invoices, and delivered the check in the amount of $85,581.42 for the

August invoices. [Pl. Ex. 8]. Keller testified that, essentially, the May invoices were paid of from H2S's own funds advanced for the August invoices. [Tr.46]. There was no other paperwork, including significantly no other individual assignment/purchase document prepared to effect the sale, like the May, 1999, transaction but unlike the 1996-1997 transactions.

Smigelski and Thomas both admitted that they did not do anything to investigate liens, because Baker was a pre-existing client. Smigelski thought they had the paperwork in place, having forgotten about the release of the UCC-1. He admits that one of his partners, Dick Herrick, was not in favor of the sale, unless the old invoices were paid off. But Smigelski credibly said that he "trusted his conversation with Bob." In fact, he felt good about the transaction because of the long term relationship with Keller, both the personal relationship and the business relationship where H2S had previously been paid. Smigelski credibly denies both that the transaction was anything other than a sale of accounts, and that he agreed with Keller that Baker could repay H2S at some indeterminate time at the sale of the company. Keller insists that both transactions were otherwise, but even according to his testimony, his knowledge of the negotiations was second-hand at best, because he insists that Sheehan negotiated the transactions, which of course Sheehan credibly denies.

For the same reasons described above with respect to the May, 1999, transaction, and based on Smigelski's testimony, the court finds that repayment upon the sale of the business, as opposed to upon receipt of the proceeds, was not a term of the August, 1999, transaction. It is even clearer with respect to the August, 1999, transactions, highlighted by Keller's September 28, 1999, fax where he admits holding H2S invoices.

Thomas finally drafted and sent Baker a demand letter, a year later, in August 2000.

[Pl. Ex. 18]. One line of that letter says that "You [Keller] have told us that this debt would be paid upon the sale of the company." The court finds, however, that those discussions to which Thomas is referring in her letter occurred long after the August, 1999, transaction was negotiated, not contemporaneously with the purchase. Keller admits that during the last quarter of 1999 and first quarter of 2000, a new prospective purchaser appeared, and that he shared this information at that time with both Dick Herrick and Smigelski, as a way of repaying the now long overdue invoices, upon which Baker had been paid and then spent the funds. [Tr. at 50-53].

Smigelski said, and the court finds, that he found out about the Key Bank encumbrance when H2S received "a letter informing H2S that Baker was filing bankruptcy." In response to the critical question "Did you have knowledge of the Key Bank financing statement?", Smigelski said he "probably would have to answer no." But Smigelski was then adamant that he would not have purchased Baker's receivables if he knew of the Key Bank UCC, for two reasons. First, it was contrary to the H2S business plan as a factor, not a lender, and second, he understood that H2S would not be first in line to collect, even if it owned the receivables. While Smigelski said Key Bank was not mentioned in the meeting, he also admitted that Keller never represented to him that there were *no* encumbrances on the receivables.

The Delp transaction did not close in September or any other time. Baker received payment on all of the factored August invoices. Most of the customer payments were received in August and September, 1999. [Pl. Ex 24]. Two of them, however, were received in October, 1999, after it was clear the Delp transaction would not be closing in September. It is not known when it was definitively a dead transaction. The funds paid on the purchased invoices were all deposited in

Baker's general accounts and used to pay other bills, at Keller's direction, including the funds from the October payments. Throughout this time, until Baker closed, Keller continued to be paid has salary, although he and other members of his family, including his mother [Tr. 59-60], also injected funds into the company at various times.

Thomas and Vaughan had a number of conversations about the status of the unpaid invoices during the fall, and in November, Thomas began sending Baker the statements adding a monthly service fee. Smigelski began calling Keller, and his calls were ignored. Ultimately, Baker's assets were sold in August, 2000, and the proceeds of sale turned over to Key Bank. H2S learned of the sale from a letter Keller sent dated August 8, 2000, in which it reported that "KeyBank, our principal lender, has a security interest in essentially all of our assets. The assets will be sold and the proceeds delivered to Key Bank. We expect the proceeds will not be sufficient to pay Key Bank in full. There are no funds for payment to unsecured creditors." [Pl. Ex.18]. Thereafter, Smigelski met with Thomas and was reminded that H2S had released its UCC-1 in 1997 and was indeed an unsecured creditor of Baker. Although Keller testified repeatedly that he never intended *not* to pay H2S, the fact is that H2S was never paid for the $91,044.06 in invoices it purchased from Baker in August, 1999, for $85,581.42.

D. The Adversary Proceeding

On May 4, 2001, Keller filed individually a voluntary petition for relief under Chapter 7 of the Bankruptcy Code [Case # 01-32853, Doc. #1]. On August 3, 2001, H2S timely filed this adversary proceeding objecting to the discharge of Keller's alleged personal liability to H2S. An amended complaint was filed on February 28, 2003. [Doc. 14]. H2S asserted five claims in its amended complaint with respect to the August, 1999, factoring transaction. The first claim alleged a willful and malicious conversion of H2S's property within the discharge exception of § 523(a)(6). The second and third claims alleged fraudulent misrepresentations by Keller within the discharge exception of § 523(a)(2)(A), one for the omission to advise H2S of the Key Bank security interest and one for the representation that Keller would collect the factored invoices and then pay the proceeds to H2S. The fourth claim sought to pierce the Baker corporate veil under Ohio law. The fifth claim sought punitive damages under Ohio Revised Code § 2315.21(C) and 11 U.S.C. § 523(a)(6). In addition to punitive damages, H2S seeks damages of $91,044.06, pre- and post-judgment interest, and attorney's fees.

At trial, Keller orally moved for involuntary dismissal of H2S's claims at the conclusion of H2S's case. The Court granted Keller's motion in part, by dismissing the fourth and fifth claims of the amended complaint for reasons stated on the record. The court denied Keller's motion as to the first, second, and third claims of the amended complaint, which remain for decision.

II. Law and Analysis

The surviving claims from H2S's amended complaint allege conversion and fraudulent misrepresentation by Keller. For claims made under 11 U.S.C. §523 (a)(2)(A) and (6), H2O has the burden of proving by a preponderance of the evidence each element of its causes of action. *Grogan*

v. Garner, 498 U.S. 279, 291, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991); *National City Bank v. Wikel* (*In re Wikel*), 229 B.R. 6, 9 (Bankr. N.D. Ohio 1998). Exceptions to discharge are to be strictly construed against the creditor and liberally in favor of the debtor. *Rembert v. AT&T Universal Card Servs.* (*In re Rembert*), 141 F.3d 277, 281 (6th Cir. 1998), *cert. denied.* 525 U.S. 978, 119 S.Ct. 438, 142 L.Ed.2d 357(1998).

A. 11 U.S.C. §523 (a)(6): Conversion

H2S's first claim is based on "conversion" under 11 U.S.C. §523 (a)(6), which states as follows:

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt–
>
> (6) for willful and malicious injury by the debtor to another entity or to the property of another entity;....

Setting aside the issue of whether Keller, individually, as opposed to Baker, owes H2O any debt arising out of a willful and malicious injury to H2O or its property,[1] the court will examine first whether a "willful and malicious" injury within the meaning of § 523(a) has occurred. Generally, § 523(a)(6) relates to tortious conduct and not to breach of contracts, even if knowing. *Salem Bend Condo. Ass'n, Section One v. Bullock-Williams* (*In re Bullock-Williams),* 220 B.R. 345

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[1] To the extent Keller is bound by the personal guaranty (which the court finds of questionable validity due to its execution after signature of the Security Agreement, its phantom date and issues with the effectiveness of the Security Agreement in the first instance, as will be explained below), § 523(a)(6) does not encompass a breach of contract claim unless the same act also constitutes an intentional tort such as conversion. *America First Credit Union v. Gagle* (*In re Gagle*), 230 B.R. 174, 184 (Bankr. D. Utah 1999)(citing *Aldus Green Co. v. Mitchell* (*In re Mitchell*) 227 B.R. 45, 52 (Bankr. S.D.N.Y. 1998)).

(6th Cir. B.A.P. 1998)(applying *Geiger*); *In re Riso*, 978 F.2d 1151, 1153-54 (9th Cir. 1992).

The Supreme Court interpreted "willful and malicious injury" as used by Congress in § 523(a)(6) in *Kawaauhau v. Geiger*, 523 U.S. 57, 118 S. Ct. 974, 140 L.Ed.2d 90 (1998). The Supreme Court explained:

> We confront this pivotal question concerning the scope of the 'willful and malicious injury' exception [to discharge]: Does § 523(a)(6)'s compass cover acts, done intentionally, that cause injury...or only acts done with the actual intent to cause injury (as the Eighth Circuit ruled)? The words of the statute strongly support the Eighth Circuit's reading. The word 'willful' in (a)(6) modifies the word 'injury' indicating that nondischargeability takes a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury...Moreover, as the Eighth Circuit observed, the (a)(6) formation triggers in the lawyers mind the category 'intentional torts,' as distinguished from negligent or reckless torts. Intentional torts generally require that the actor intend 'the consequences of an act,' not simply 'the act itself.'

Before *Geiger*, it was well- established in the case law that debts resulting from conversion of collateral may be excepted from discharge under § 523(a)(6). *Wikel,* 229 B.R. at 9. In dicta, the Supreme Court noted that while "not every tort judgment for conversion is exempt from discharge," those involving willful and malicious injury as opposed to negligent or reckless acts of improper dominion over the property of another may still meet the standard under § 523(a)(6). It is therefore clear that conversion continues to be a basis for nondischargeabilty under § 523(a)(6), as long as it was committed with the requisite intent to cause harm and not merely negligently or recklessly. *Id.* at 10.

As a number of courts since *Geiger* have observed, applying the standard enunciated by the Supreme Court has proven difficult, in part because the Court described what a willful injury is not, but gave little guidance as to what it is. *ABF,Inc. v. Russell (In re Russell),* 262 B.R. 449,453 (Bankr. N.D. Ind. 2001). Ascertaining the actual intent to cause injury of debtors operating in

situations similar to Keller's effectively requires a subjective analysis of the totality of the circumstances. Here, as in many other cases, "the wrongful use of a creditor's collateral [property] often represents a last ditch effort to save a failing business or personal finances and is motivated by the debtor's genuine, but unrealistic, belief that a change in fortune will permit the payment of all its debts, including the debt to the secured creditor." *Id.*; [Tr. 47-48].

Moreover, not only must the injury be willful, it must also be malicious, as an element of proof distinct from willfulness. *Markowitz v. Campbell (In re Markowitz)*, 190 F.3d 455,463, 465 n.10 (6th Cir. 1999).

Keeping in mind the standards of *Geiger* and its admonition that some but not all acts of tortious conversion constitute a willful injury under § 523(a)(6), the court turns to the issue of whether a conversion has occurred as claimed by H2S. In this case, the issue is money and not other forms of collateral, such as machinery, equipment or inventory. H2S allowed Baker to receive checks from its customers on factored invoices, to deposit them in its general account and then "immediately" pay H2S from its own account the amount of the money received. Baker was never required to turn customer checks directly over to H2O, despite the terms of the Security Agreement. This was the course of performance that developed between the parties on the 1996-1997 transactions and continued with the 1999 transactions.

Another Ohio bankruptcy court has recently and persuasively examined the standard for proving the conversion of money under Ohio law in *Howard v. McWeeney (In re McWeeney)*, 255 B.R. 3, 5-6(Bankr. S.D. Ohio 2000). In *McWeeney* the court explained the Ohio standard for proving a conversion of money as follows:

> Under Ohio law an action for conversion of *money* only arises where: (1) there exists an obligation on the part of the defendant to deliver to the plaintiff specific money; and (2) the money is capable of identification. *Haul Transport of Va., Inc. v. Morgan*, 1995 Ohio

> App. LEXIS 2240, No. CA 14589, 1995 WL 328995, at *3-4 (Ohio Ct. App. June 2, 1995); *NPF IV, Inc. V. Transitional Health Servs*, 922 F. Supp. 77, 81 (S.D. Ohio 1996) ....In Ohio, as in most jurisdictions, the standard for proving conversion of money is an exacting one. To establish the first element under Ohio law the plaintiff must demonstrate that the defendant owes an obligation to deliver 'identical' money as opposed to a certain sum of money. *Haul Transport*, 1995 WL 328995 at *4. The latter situation creates only an indebtedness stemming from a debtor-creditor relationship....As mentioned, the second element that must be shown under Ohio law to support a claim for tortious conversion of money is that the specific money that is to be set aside by promise, agreement or fiduciary duty must be identifiable.

The court cannot find that the actions of Keller and Baker meet these exacting elements of proof. There are several facts the court simply cannot overcome that prevent it from finding for plaintiff on its claim of a willful and malicious conversion of H2S's property. In the first instance, H2O has failed to prove that Baker was required to deliver to it the identical funds delivered to Baker by its customers in payment of the invoices H2S purchased in August, 1999.

H2S points to the 1997 Security Agreement, and paragraph 46 thereof requiring Baker to hold the payments from its customers in trust for H2S, as the source of a requirement that Baker deliver to H2S the identical funds received. There are two problems with this argument. The court does not believe, as a matter of law, that the Security Agreement ever became effective between the parties in its own stead as a master agreement, because H2S never signed it. To the extent the agreement was not to be performed within one year, the statute of frauds applies, which requires only that the agreement be signed by the party against whom it is being enforced. Ohio Rev. Code § 1335.05. Similarly, to the extent the agreement is subject to Article 9 of the Uniform Commercial Code, Article 9 requires only that the debtor have "authenticated" the agreement. Ohio Rev. Code §1309.203(B). But ordinary contract principles otherwise determine who is bound by the written provisions of an agreement. *See Brumm v. McDonald & Company Secur., Inc*. 78 Ohio App. 3d 96, 103 (Ross Cty. 1992)(noting that parties can become contractually bound absent their signatures). However, "it is [also] well established that courts will give effect to the manifest intent of the parties where there is clear evidence demonstrating that the

parties did not intend to be bound by the terms of an agreement until formalized in a written document and signed by both." *Richard A. Berjian, D.O., Inc. v. Ohio Bell Tel. Co.*, 54 Ohio St.2d 147, 151 (1978).

Here, that intent is clearly expressed by paragraph 67 of the document, drafted by H2S, providing that the agreement became effective when executed by an authorized officer of H2S. It never was. Thereafter in 1996 and 1997, however, Baker signed individual assignment documents for each separate transaction that incorporated the terms and conditions of the Security Agreement into them, which separate documents did not require H2S's signature. The court believes that each of these individual documents incorporated the terms of the unsigned Security Agreement into them as the parties' terms of agreement for each of those specific transactions, notwithstanding H2S's failure to sign the master Security Agreement. But there were no such documents signed by Keller or anyone else acting on behalf of Baker as to the May or August, 1999, factoring transactions. The court finds that they were oral agreements that did not incorporate all of the terms of the unsigned Security Agreement, including the hold in trust provision, into them. Smigelski and his counsel made much at trial about neither party having taken actions to "terminate" the 1997 Security Agreement. This was irrelevant in the court's view, as it never became effective by its own terms absent H2O's signature.

Moreover, even if the Security Agreement became effective, and even if it were determined that the August,1999, factoring transaction was governed by it, the parties' own course of dealing modified its terms. H2O had *never* required Baker to deliver to it the identical money received from its customers, with this waiver becoming yet more pronounced with the lump sum payoff of the late 1997 transactions by a cashiers check in connection with the Key Bank closing and the lump sum payoff of the May, 1999, transaction with a Baker check in connection with the August, 1999, transaction. Smigelski admitted that the parties agreed that Baker would collect the August, 1999, invoices, because they had already been sent out to customers, and then pay H2S. For these reasons, the court

cannot find that Baker or Keller had an obligation on the August, 1999, transaction to deliver to H2S the "identical" money Baker received in payment of the factored invoices.

Likewise, the court cannot find that H2O has demonstrated the second element of proof of a conversion of money, namely that the specific money that is to be set aside be "identifiable." The Baker customer payments were deposited into Baker's general accounts, where they were commingled with whatever other funds were there. There was never a lockbox requirement, or similar separate account set up, into which Baker and Keller then intentionally prevented the deposit of funds or from which Baker and Keller intentionally diverted funds. Smigelski admitted that H2S did have lockbox requirements with some of its factoring customers, but never did with Baker. *See NPF IV*, 922 F. Supp at 81 and cases cited therein.

The facts of this case are very similar to the facts in *McWeeney* and the cases upon which it relies. In *McWeeney*, the plaintiff did not prevail under § 523(a)(6) on his action for conversion, because the parties' oral agreement only obligated defendant/debtor to pay a certain sum of money to plaintiff, not "identical" money that was earmarked or otherwise set-aside. The fact that the funds were commingled in debtor's business checking account meant that they were not identifiable. The funds were therefore not convertible or converted chattels. Thus, plaintiff was only a creditor and could not recover in an action for conversion.

H2S argues that *McWeeney* is distinguishable because the parties therein never had a *written* agreement requiring the debtor to separate specific funds received from the plaintiff's patients and then deliver those funds to plaintiff. Here, H2S argues, there was such a written agreement, containing the hold in trust, non-interference and sole property provisions. As already explained, however, the court disagrees with H2S on that point. And to the extent there was such an agreement, it

was wholly vitiated by the parties' course of dealing. *McWeeney* is persuasive authority to this court, and not readily distinguishable as H2S argues.

Not only does the court find that H2S has failed to prove a conversion, even if it had, the circumstances also bear on the question of Keller's actual intent to injure H2S or its property. Only debts for willful and malicious conversion by the debtor of the property of another entity are excepted from discharge. *KMK Factoring, L.L.C. v. McKnew (In re McKnew)*, 270 B.R. 593, 634-640 (Bankr. E.D.Va. 2001) (discussing at length application of Section 523(a)(6) to conversion cases). Liability for the injury is excluded only if both elements, willfulness and malice, are present. Generally, "willfulness" applies to the debtor's volition in causing the injury, and "malice" describes the debtor's motivation or state of mind. As the bankruptcy court in *Russell* recognized, relying upon the Supreme Court's decision in the oft-cited case *Davis v. Aetna Acceptance Co*., 293 U.S. 328, 332, 55 S.Ct. 151, 153, 79 L.Ed. 393 (1934), "a course of dealing between a debtor and a creditor, in which the creditor has repeatedly consented to, acquiesced in, or tolerated a disposition of its collateral in contravention of the security agreement may also constitute a justification or excuse" that will help prevent even an intentional injury from also being a malicious one. 262 B.R. at 456; *America First Credit Union*, 230 B.R. at 183, n.12(citing Restatement (Second) of Torts §§ 887-895).

The court finds that H2S has failed to prove by a preponderance of the evidence that Keller is liable for a "willful and malicious injury" under § 523(a)(6).

B. 11 U.S.C. §523 (a)(2)(A): Fraudulent Misrepresentation

Plaintiff's second and third claims are based on alleged fraudulent misrepresentations under 11 U.S.C. §523 (a)(2)(A), which states:

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from 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.

In order to except a debt from discharge under § 523(a)(2)(A), a creditor must prove, by a preponderance of the evidence, each of the following elements: (1) the debtor obtained money through a material misrepresentation that, at the time, the debtor knew was false or made with gross recklessness as to its truth; (2) the debtor intended to deceive the creditor; (3) the creditor justifiably relied on the false representation; and (4) its reliance was the proximate cause of the loss. *Rembert,* 141 F.3d at 280.

The first question the court must confront under § 523(a)(2)(A) is whether Keller owes any debt to H2S for money, property or services obtained by one of the enumerated prohibited acts. Keller argues that, at all times, he was acting only as an agent for the corporation, and that there is no evidence that he himself, as opposed to Baker, obtained any money, property, services or credit from H2S. H2S bought the invoices from and advanced money to Baker, not Keller. And although he might arguably be liable on the personal guaranty, Keller correctly asserts that is at most a contractual obligation the breach of which does not fall within the exception to discharge of § 523(a)(2)(A).

The Sixth Circuit case *Brady v. McAllister (In re Brady)*, 101 F.3d 1165, 1172 (6th Cir. 1996), overcomes Keller's argument. In *Brady*, the Sixth Circuit adopted what has been referred to as the "benefits theory" as to whether a debtor must personally receive money or services as the result of a false representation in order for the § 523(a)(2)(A) exception to apply. The Sixth Circuit held

that a creditor must prove that the debtor directly *or indirectly* obtained some tangible or intangible financial benefit in order to prevail under § 523(a)(2)(A). It does not require, however, that the debtor directly and personally obtain every dollar lost by the creditor. In *Brady*, the plaintiff creditor successfully proved that the debtor sufficiently benefitted when a corporation that he controlled was the recipient of $40,000.00 from the creditor.

In *Rembert*, the Sixth Circuit stated the first element of a claim under § 523(a)(2)(A) as requiring proof that the "debtor" obtained money, credit, etc. This court does not, however, view the Sixth Circuit's statement of the elements of a § 523(a)(2)(A) claim in *Rembert* as overruling *Brady*. In *Rembert*, the issue was the dischargeability of the debtor's credit card debt. There was simply no issue, as there was in *Brady*, that the debtor had received direct credit from AT&T Universal as a result of her alleged misrepresentation of her intention to repay.

H2S has similarly proven that Keller received benefits from H2S's payment of $85, 581.42 to Baker. By the time of the August, 1999, transaction, Keller was the sole shareholder, officer and director. He was also a company employee, and continued to receive his salary, even when H2S was not getting repaid. He and his mother had also loaned the company funds, and to the extent he was motivated to keep the company alive for sale in selling invoices to H2S, part of that motivation involved repaying certainly his mother's loans if not his own. Keller's benefit from H2S's purchase of invoices from Baker meets the receipt of benefits test relied upon by the Sixth Circuit in *Brady*.

Also, under Ohio law, corporate directors and officers can be held personally liable for fraud even thought the corporation may also be liable, and plaintiffs need not pierce the corporate veil to hold individuals liable who allegedly personally committed fraud while acting within the scope

of his employment or corporate duties. *See Yo-Can, Inc. v. The Yogurt Exchange, Inc.*, 149 Ohio App.3d 513, 525-527 (Mahoning Cty. 2002). This is an alternate basis for Keller's direct liability for any fraud committed beyond any breach of contract that also occurred for which he would be liable.

The court will next address the elements of H2S's claims under § 523(a)(2)(A), first with respect to Keller's omission to advise H2S of the Key Bank security interest in the receivables sold in August, 1999.

The first element is that a material misrepresentation occurred that the debtor knew was false or was made with gross recklessness as to its truth. The case law is well-settled that an omission to state or concealment of a material fact satisfies the material misrepresentation requirement of § 523(a)(2)(A). *Wings & Rings, Inc. v. Hoover (In re Hoover)*, 232 B.R. 695, 700 (Bankr. S.D. Ohio 1999)(failure to reveal sales tax liability to business purchaser a material misrepresentation); *see Metcalfe v. Waters (In re Waters)*, 239 B.R. 893, 901 (Bankr. W.D. Tenn. 1999). As set forth above, the court found that Keller, not Sheehan, negotiated the August, 1999, factoring transaction with Smigelski. The court also found that H2S was not aware of the Key Bank security interest at that time, and credited Smigelski's testimony that Key Bank was never discussed at his meeting with Keller, where they discussed the factoring transaction. Although Keller testified that he never told H2S there was *no* Key Bank encumbrance on the receivables, as already explained omissions, if material, can be equally actionable as affirmative misstatements of fact. (Of course, Keller also denied negotiating the transaction, so there is minimal probity to that statement). H2S never learned of Key Bank's continuing security interest until Keller's August 8, 2000 letter notifying H2S of the sale of the business, long after the fact.

The omission was material. It was critical for H2S in evaluating whether it wanted to buy the receivables in issue to know whether they were encumbered. Whether the Security Agreement was effective or not, the inclusion in it of standard terms as to title to the accounts and a representation of no encumbrances evidences the materiality of such a fact. The existence of a pre-existing lien on the account being sold materially enhanced H2S's risk of not getting paid. It was entitled to evaluate that risk on its own, and make a fully informed decision whether to enter into the transaction. Keller deprived H2S of that ability. He improperly self-evaluated that risk for H2S in his conversations with Sheehan, which was wrongful from the standpoint of his dealings with H2S.

The second element, and the closest one in the court's view, is that H2S must prove that Keller intended to deceive H2S in omitting to report the Key Bank encumbrance on the accounts being sold. As other courts have noted in confronting this element, "[i]t is often difficult to determine a debtor's true intent. No debtor is going to get on the stand and admit to fraudulent intent. As a result, 'plaintiff may present evidence of the surrounding circumstances from which intent may be inferred.'" *Commercial Bank & Trust Co. v. McCoy (In re McCoy)*, 269 B.R. 193, 198 (Bankr. W.D. Tenn. 2001). Whether a debtor possessed an intent to defraud a creditor within the scope of § 523(a)(2)(A) is measured by a subjective standard. *Rembert*, 141 F.3d at 281.

The court finds here that it was more probable than not that Keller had the requisite intent to defraud H2S in failing to raise the Key Bank encumbrance. That he was conscious of the lien and its impact on the transaction, albeit also from the standpoint of Key Bank's collateral position, is shown by his discussions with Sheehan on the subject. It was clearly a considered concern, and rightly so. The circumstances of his company were becoming increasingly dire, and Keller's efforts throughout this time period have an air of desperation about them, especially as

illustrated by his September fax to Sheehan. Contrary to showing that his only motivation was to save the business and get it through to sale, the court views Keller's mind-set at that time as one of a willingness to do anything necessary to get the funds necessary to make payroll and pay suppliers, including omitting material facts from his discussions with H2S and taking the risk that it would not ultimately matter if the Delp transaction closed. As far as H2S, as a factor, the continuation of the business was irrelevant to its ability to get paid on the existing accounts it purchased, as long as they were clean of other encumbrances, unlike a lender whose collateral value otherwise depended on the business continuing in operation. *Cf. Wikel*, 229 B.R. at 10-11.

Keller is a college-educated businessman with long experience. Given the contents of the Security Agreement he signed and with which he was familiar, whether effective or not, and the dynamics of the resolution of the competing Key Bank–H2S interests in 1997 in connection with the bank loan to Baker, the court infers that Keller was well-aware of the importance of a pre-existing lien on receivables to a factor like H2S, and chose not to raise the issue on the chance that it would queer the deal and leave him with nowhere else to turn for immediate operating cash. He would worry about paying H2S later, rolling the dice that the Delp deal would close. But Baker needed the cash in the first place. The fact that Keller self-servingly testified that he never intended *not* to pay H2S, as most debtors do, is irrelevant. Keller was focused on getting the dollars in the door, however it needed to happen. That was accomplished, although the court believes Keller was aware it would not have been if the Key Bank encumbrance and lending relationship status was raised with Smigelski.

The court is persuaded that, based on all of the circumstances, Keller intended to deceive Smigelski in not raising the existing Key Bank encumbrance as part of his sale of Baker's

encumbered receivables to H2S in August, 1999. This was an intentional, not accidental or reckless, omission.

The third element H2S must prove is that it "justifiably relied" on Keller's omission. The court finds from Smigelski's testimony that there was actual reliance. He credibly stated that, had H2S known of the Key Bank security interest, it would not have purchased the receivables. Under such circumstances, the purchase would have been outside the principals' business plan, and he understood that it meant H2S would then be second in line as to any pre-existing lienholder.

Keller argues two points in contravention of H2S's alleged actual reliance. First, Keller argues that Smigelski thought in August, 1999, that H2S already had a filed UCC-1 on all Baker accounts receivable. (He did think that, but he was wrong). So, Keller argues, Smigelski did not care if anybody else also had liens on the receivables. This is a close question, and hard to evaluate when the fraudulent representation in issue was an omission. But the court believes that, under Baker's distressed circumstances and with an impending sale of the business, the existence of an alleged security interest on all of the client receivables was treated as a failsafe collection device by H2S, not as a protection in its initial purchase of select accounts. Second, Keller argues that H2O knew of the Key Bank security interest in 1997, so it must have known of it in 1999. But Smigelski did not, and the court found his testimony credible on this point.

With Smigelski having actually relied on the omission of Key Bank's preexisting lien on Baker's receivables, the further issue is whether that reliance was justifiable. This level of reliance was established by the Supreme Court in *Field v. Mans*, 516 U.S. 59, 116 S.Ct. 437, 133 L.Ed.2d 351 (1995). This case changed the level of reliance in § 523(a)(2)(A) actions from a reasonable one, of the objective person, to a justifiable one. *Id.*, at 73. As a result, the Supreme Court stated that an

inquiry as to a creditor's reliance is a subjective one that depends on the facts and circumstances of each case. Here, Keller argues that H2S could not have justifiably relied on Keller's omission as to the Key Bank lien because it was a matter of public record.

While some support can be found for the proposition that a creditor can never justifiably rely on the omission of information that is a matter of public record, such as Key Bank's UCC-1 financing statement, those cases apply state law. *See, e.g., Steele v. First National Bank in Wichita*, 1992 WL 12318, 1992 U.S. Dist. LEXIS 90-1592-B (D. Kansas May 26, 1992)(applying Kansas law); *Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank*, 731 F.2d 112, 123 (2d Cir. 1984)(applying New York law); *Locher v. Brown*, 1982 WL 3546, 1982 Ohio App. LEXIS 14248 (Scioto Cty. Oct. 4, 1982)(applying Ohio law to a real estate transaction). However, the Supreme Court found that when Congress enacted § 523(a)(2)(A), it intended to adopt the common law understanding of the terms used in the statute, rather than the law of any particular state. *Field*, 516 U.S. at 69-70. The facts in *Field* actually involved an omission of fact (i.e. that certain real estate was transferred to a newly formed partnership) that was a matter of public record. *Id*. at 61-63. The lower courts found that the creditor had not reasonably relied on the omissions since the matter omitted was a matter of public record, and that a reasonable person in the creditor's position would have checked for any conveyance. The Supreme Court rejected the lower courts' reasonable reliance application. Instead, it held that § 523(a)(2)(A) requires proof of the lesser standard of justifiable reliance. Under this standard, a creditor will be found to have justifiably relied on a representation even though "he might have ascertained the falsity of the representation had he made an investigation." *Id.* at 70.

Under *Field*, contrary to Keller's argument, the fact that Key Bank's UCC-1 was a matter of public record does not automatically defeat H2S's justifiable reliance in the absence of the

omitted information. Smigelski trusted Keller, and had a longstanding personal and business relationship with both Keller and Baker. *In re Phillips*, 804 F.2d 930, 933 (6th Cir. 1998)(applying old reasonable reliance standard, found where parties had known each other for 25 years); *Kuper v. Spar (In re Spar)*, 176 B.R. 321, 328 (Bankr. S.D.N.Y. 1994)(addressing impact of friendship under old standard). For those reasons, he "felt good about the transaction" and never undertook a lien search, which would have occurred with a new client and which would have revealed Key Bank's lien. Also, Baker had always repaid H2S, even if late and even if in a lump sum not actually connected with invoice receipts. Lastly, given the immediate time frame Keller himself set for the factoring transaction, H2S was justified in not undertaking a lien search, which also would have disclosed the absence of its former financing statement from the public record. For all of the foregoing reasons, the court finds that H2S justifiably relied on Keller's omission as to the Key Bank lien.

H2S's final element of proof is that its reliance was the proximate cause of the loss. The connection between the reliance and a loss by H2S is clear on the record. As the court found based on Smigelski's testimony, H2S would not have advanced $85,581.42 in August, 1999, to Baker to purchase the designated receivables had it been aware of the preexisting Key Bank lien. The causal link is direct. H2S has met its burden of proof on the final element of its § 523(a)(2)(A) claim of a false representation by Keller's omission to report the Key Bank lien to Smigelski.

Because the court has determined that H2S is entitled to prevail under § 523(a)(2)(A) on at least one misrepresentation, it is unnecessary to determine H2S's third claim as to Keller's intention to deliver funds paid on the invoices to H2S as of the time of the transaction. To the extent, however, this claim otherwise becomes relevant, the court finds that this allegation is simply a breach of a promise made as part of the terms of the transaction, and not a fraudulent misrepresentation by

Keller to induce the purchase. *Spar,* 176 at 327 (in order for a representation to be false under § 523(a)(2)(A), the representation must encompass statements that falsely purport to depict current or past facts, not mere promises of performance in the future). And while misrepresentation of an intent to perform can sometimes amount to a fraudulent misrepresentation, Smigelski's testimony never identified exactly what words Keller used or the strength of the promise such that the court could make a finding of a misrepresentation by Keller in this case. It was was too general and non-specific to meet H2S's burden of proof on that element.

Moreover, under all of the circumstances, the court cannot find H2S's reliance actual or justifiable, even if it was more than a promise as part of the transaction that was simply breached. Keller and Baker had not delivered funds to H2S "immediately" after payment from its customers on either of the most recent sets of transactions in March,1997, and in May, 1999. On both occasions H2S was paid off by lump sums unrelated to the timing of invoice payments by customers. H2S was unjustified in thinking Keller would do so now at a time of financial distress, particularly with the funds to be deposited in Baker's general account, which Smigelski was readily willing to permit. As the Supreme Court aptly noted in *Field*, sometimes "[t]he subjectiveness of justifiability cuts both ways, and reasonableness [still] goes to the probability of actual reliance." *Field*, 516 U.S. at 76.

III. H2O's Damages

H2S is claiming the entire amount of the invoices if purchased from Baker in August, 1999, as its basic measure of compensatory damages. That amount is $91,044.06, but the amount H2S actually advanced to Baker in reliance on Keller's omission was $85,581.42.

The court finds that H2S is entitled to entry of a nondischargeable judgment in the amount of only the $85,581.42 amount it paid Baker, and not the entire amount of the unpaid

invoices.[2] The basis for H2S's § 523(a)(2)(A) claim as to the omission is that it never would have entered into the transaction if it had been fully and properly informed of all material facts by Keller. Section 523(a)(2)(A) only excepts from discharge debts "to the extent" obtained by one of the prohibited acts. Similarly, under Ohio law, a person injured by fraud is entitled to damages that will compensate for the wrong suffered and which have resulted proximately from it. *Foust v. Valleybrook Realty Co.*, 4 Ohio App. 3d 164 (Wood Cty. 1981). Here, that is the amount H2S paid for the invoices. H2S is not entitled to claim the full benefit of a transaction it says it was fraudulently induced to enter and never would have entered into in the first place but for the fraudulent omission of Keller. The larger amount represents the breach of contract damages for which Baker, and arguably Keller to the extent the personal guaranty is valid, are liable. Breach of contract damages are not, however, excepted from discharge. That amount does not represent the tort damages proximately resulting from Keller's misrepresentation and therefore excepted from Keller's discharge.

In making this determination of damages to be excepted from Keller's discharge , the court is carefully mindful of the Supreme Court's decision in *Cohen v. De La Cruz*, 523 U.S. 213, 118 S.Ct. 1212, 140 L.Ed.2d 341 (1998). In *Cohen*, plaintiffs had obtained a judgment against the debtor in state court before the bankruptcy case commenced. The judgment included an award of punitive damages, as well as treble damages, attorney's fees and costs under the New Jersey Consumer Fraud Act. The Supreme Court rejected the debtor/petitioner's argument that the treble damages, attorney's fees and costs part of the state court judgment were dischargeable because they did not reflect money,

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[2] If the court had found under § 523(a)(6) that Keller had willfully and maliciously injured H2S or its property, the full $91,044.06 would have been awarded by the court as the value of the property injured.

property or services "obtained" by the debtor through the fraud.

Here, the court readily acknowledges that if Keller is liable for attorney's fees and prejudgment interest, which will be addressed below, and if he were liable for punitive damages, which the court already determined at trial he is not, such awards would also be nondischargeable under *Cohen.* The court also readily acknowledges that, in isolation, some of the broad language of *Cohen* could be read to entitle H2S to the full amount of $91,044.06, particularly the language evincing the Court's belief that Congress did not intend the language of the statute to impose any "restitutionary limit" on nondischargebalility under § 523(a)(2)(A). Likewise, existing case law involving attorney's fees that arise from contracts in the context of § 523(a)(2)(A) cases could arguably support the larger amount as damages to H2S. *See, e.g., Wegman's Food Markets, Inc. v. Lutgen,* 1999 WL 222605*,* 1999 U.S. Dist. LEXIS 5160 (D. W.D.N.Y. 1999) and cases cited therein.

This court nevertheless believes that, after *Cohen*, bankruptcy courts in § 523(a)(2)(A) cases must still distinguish between creditor losses occasioned by fraud and creditor losses occasioned only by breach of contract. None of the examples cited by the Supreme Court in support of its concern and reasoning that the petitioner's argument would result in unfairly discharging losses exceeding the value received by a debtor are remotely similar to this case. This is simply not a case like a contractor representing one grade of materials and being paid accordingly, then fraudulently substituting a lesser quality that causes repair and replacement damages far exceeding the amount originally paid to the contractor.

Other bankruptcy courts have still carefully made the distinction between fraud damages and contract damages after *Cohen* in cases like this one. *See Sandak v. Dobrayel (In re Dobrayel)*, 287 B.R. 3, 24-25 (Bankr. S.D.N.Y. 2002)(carefully and thoroughly distinguishes between

building contractor fraud and plain breach of contract in determining damages and dischargeability); *Novartis Corp. v. Luppino (In re Luppino)*, 221 B.R. 693, 703-04 (Bankr. S.D.N.Y. 1998)(analysis still required on each debt to determine whether it was proximately caused by § 523(a)(2)(A) acts). The court believes this is still the correct approach under *Cohen*, and has so applied it in reaching its decision. *Cohen* requires the court to focus on all damages proximately caused to the creditor by the wrongful act, not just the amount fraudulently received by the debtor.[3] In this case and on this record, those amounts happen to be the same, and are the $85,581.42 amount.

H2S also seeks attorney's fees. After *Cohen*, the American Rule on recovery of attorney's fees still applies in § 523(a)(2)(A) cases. *America First Credit Union*, 230 B.R. at 184. There must therefore be a statute, a contract or other specific rule of common law authorizing an award of attorney's fees. The court does not find any legal or factual basis for an award of attorney's fees to H2S, beyond those that were previously awarded as a discovery sanction.

There is no basis in the Bankruptcy Code for an award of attorney's fees to a creditor successfully prosecuting a § 523(a)(2)(A) claim *Cf.* 11 U.S.C. § 523(d)(debtors shall be awarded attorney's fees in certain circumstances not present here). Nothing in § 523(a)(2)(A) indicates that Congress intended the prevailing party to be awarded fees.

The Security Agreement and the personal guaranty might arguably form a basis for Keller's liability for H2S's attorneys fees. But the court has already expressed its view that these contracts were not the basis for the August, 1999, transactions, to the extent if any they were valid contracts in the first instance. Therefore, they also do not form a basis for an award of attorney's fees,

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[3] Had it not sold the receivables to H2S, Baker still would have been entitled to collect the invoices from its customers.

even under *Cohen* and cases such as *Lutgen,* applying *Cohen* to contract attorney's fee awards in the tort context under § 523(a)(2)(A).

Lastly, under Ohio law, plaintiffs who successfully prove fraud are entitled to an award of attorney's fees under certain circumstances. But this entitlement is not automatic. Attorney's fees are only appropriately awarded under Ohio law on a fraud claim where punitive damages are warranted. *Galmish v. Cicchini*, 90 Ohio St. 3d 22, 35 (2000). The record must support a finding that the legal standard for punitive damages could have been met. In turn, that standard requires a finding that the fraud has been gross or malicious. *Logsdon v. Graham Ford Co.*, 54 Ohio St. 2d 336, 339-40 (1978); *Bennice v. Bennice*, 82 Ohio App. 3d 594, 599 (Ottawa Cty. 1992). The court has already determined and dismissed H2S's fifth claim in its amended complaint in which it sought punitive damages. H2S's evidence simply does not establish the sort of malice on Keller's part necessary to justify an award of punitive damages beyond his basic liability for a fraudulent misrepresentation.

H2S also seeks an award of pre-judgment interest. The legal basis for such an award has not been identified. The court assumes that H2S's claimed basis for an award of prejudgment interest would be Ohio Rev. Code § 1343.03(C), as it is not aware of any other legal basis upon which such an award might arguably be based in this case. This statute governs prejudgment interest in civil actions based on tortious conduct and not settled by agreement of the parties. Proper procedure under the statute requires the party claiming entitlement to prejudgment interest to file a post-decision motion, and then a hearing must be held. The only basis upon which prejudgment interest may then be awarded under § 1343.03(C) is proof of a party's failure to make a good faith effort to settle the case. The court cannot make such a determination in this case from the existing trial record. So if H2S believes it has that or any other basis upon which to properly request an award of prejudgment

interest, then it will have to otherwise so establish on the record after a request made as set forth below.

IV. Conclusion

In accordance with this memorandum of decision, the court will separately enter judgment in H2O's favor on the second claim of its amended complaint in the total amount of $85,581.42, such sum also to be excepted from discharge in Keller's underlying Chapter 7 case under 11 U.S.C. § 523(a)(2)(A). The court will separately enter judgment against H2S and in Keller's favor on the first, third, fourth and fifth claims of H2S's amended complaint. However, entry of final judgment in accordance herewith will be delayed for a period of fourteen days from entry of this memorandum of decision to enable H2S to file a motion for prejudgment interest if it believes it has a legal and factual basis to do so. If no such motion is filed, the court will enter final judgment based on this memorandum of decision, including as to H2S post-judgment statutory interest but excluding any prejudgment interest. A separate order requiring any such motion to be filed during that fourteen day time period will also be entered by the court.

Mary Ann Whipple
United States Bankruptcy Judge