

Plaintiffs allege that two debts memorialized in an Arbitration Award ("Award"), issued by a National Association of Securities Dealers' Dispute Resolution Panel ("NASD Panel") on March 3, 2006 in NASD Case Number 02-03197, are nondischargeable pursuant to 11 U.S.C. §§ 523(a)(2) (debts for fraud) (First Count), 523(a)(6) (debts for willful and malicious injury) (Second Count) and 523(a)(19) (debts for violation of securities laws) (Third Count).¹

In his Partial Motion for Summary Judgment, Defendant contends that, because the parties agreed to submit all of the questions of fact underlying the nondischargeability claims to the NASD Panel, Plaintiffs failure to build a factual record to support their § 523(a) claims before the NASD Panel prohibits them from adducing additional evidence in this Court to prove the nondischargeability of the debts. Mot. at 5 ("The Miles [sic] knew that the results of the final determination by the NASD Panel were to be reported to [the bankruptcy court], yet they did not even ask the NASD Panel to enter the findings of fact necessary to show that [Defendant] engaged in the type of conduct that would make the debt arising from his prepetition conduct such that 11 U.S.C. § 523(a)(2) would render it nondischargeable.") (internal quotations omitted).

In the alternative, Defendant argues that, because the NASD Panel specifically declined to award punitive damages, Plaintiffs are collaterally estopped from relitigating their nondischargeability claims premised upon willful and malicious injury. Finally, Defendant asserts that, assuming *arguendo* this Court permits Plaintiffs to provide additional evidence in support of their

¹Plaintiffs also seek a denial of Defendant's general discharge pursuant to 11 U.S.C. § 727 in their Adversary Complaint (Fourth Count), however, Defendant has not moved for summary judgment on that claim.

nondischargeability claims, Plaintiffs have not produced sufficient evidence to survive summary judgment.

I. FACTS

At all times relevant to the Adversary Complaint, Defendant was a securities broker/dealer employed by the now-defunct Bethany Financial Advisory, Inc. ("Bethany"). Plaintiffs were novice investors who entrusted Defendant with substantial sums of money for investment purposes. Ultimately, through a course of buying on margin, Defendant lost all of the funds entrusted to him by Plaintiffs, as well as additional sums as a result of margin calls.

As a consequence, Plaintiffs filed their Statement of Claim and Request for Arbitration ("NASD Complaint") before the NASD on or about May 28, 2002. Defendant filed his Chapter 13 Petition in this Court on November 11, 2002.² As a matter of course, the NASD matter was automatically stayed. However, shortly after Plaintiffs filed the Adversary Complaint on February 20, 2004, the parties submitted an agreed order to the Court, which provided that the Bankruptcy Court would (i) abstain from consideration of certain matters set forth in the Adversary Complaint, and (ii) grant relief from stay to proceed with the Arbitration Complaint.

On June 2, 2004, the Court entered the agreed order, captioned "Agreed Order on Complaint to Determine Dischargeability of Debt, Objection of Discharge and to Obtain Relief, and Request of Defendant for Abstention in Part," (the "June 2 Order") which reads, in pertinent part:

²Defendant's case was voluntarily converted to a Chapter 11 case on February 2, 2003. The case was converted to a Chapter 7 case by Order of the Court on October 28, 2003.

Pre-trial Hearing having been held on April 26, 2004; and that the parties having agreed and stipulated at [sic] follows:

1. The Court shall abstain from consideration of the matter [sic] set forth in paragraphs seven (7) through forty-six (46) of the Adversary Complaint, grant Plaintiff's [sic] relief from the Automatic Stay to proceed with their Complaint through Arbitration Proceedings before the [NASD] which already has jurisdiction over the nature of the Complaint set forth in paragraphs seven (7) through forty-six (46) of the Adversary Complaint. NASD is deemed to be the appropriate forum to determine these securities claims since they are not based on any right created by Federal Bankruptcy Law and Plaintiff [sic] should be permitted to go forward before the NASD Forum [sic] on Arbitration, with the results of final determination there to be reported to this Court.

2. This Court shall retain jurisdiction over paragraphs forty-seven (47) through fifty (50) of the Adversary Complaint and make determination [sic] as a core proceeding.

June 2 Order at 1-2. (Emphasis added.)

Paragraphs seven (7) through forty-four (44) of the Adversary Complaint include the factual bases for the § 523 claims as well as the First, Second, and Third Counts in their entirety. Paragraphs forty-five (45) and forty-six (46) contain the first two allegations in the Fourth Count, in which Plaintiffs allege that Defendant represented that he had earned close to one million dollars in income through investments and that he would earn the same amount in the following year.

Paragraphs forty-seven (47) through fifty (50) of the Adversary Complaint, over which this Court "retained jurisdiction," contain allegations that Defendant has concealed property and assets with the intent to defraud creditors and failed to preserve information regarding his financial condition. The facts in Paragraphs forty-

seven (47) through fifty (50) are alleged exclusively in support of Plaintiffs' § 727 claim.

Following an arbitration hearing, the NASD Panel issued a six-page decision, which dedicates one and one-half pages to the procedural history of the case and two and one-half pages to a list of NASD fees assessed to the parties. With the final page of the Award dedicated to the signature of the arbitrators, there remains approximately one page of text explaining the award of damages.

The explanation is divided into three parts. The first part, captioned "Case Summary," reads, in pertinent part, "[Plaintiffs] asserted the following causes of action: unsuitability, breach of implied covenant of good faith and fair dealing, margin calls, negligence, failure to supervise, breach of fiduciary duty, and misrepresentations."³ (Award at 2.) The second part, captioned "Relief Requested," states that Plaintiffs requested rescission of all transactions, \$329,951.00 in compensatory damages, \$500,000.00 in punitive damages, and attorneys' fees and costs. (*Id.*)

The final section, captioned "Award," states that Defendant is jointly and severally liable with Bethany to: (i) Robert D. Miles in the amount of \$47,585.00 plus interest at the rate of 6% per annum from February 8, 2006, and (ii) Leonard W. Miles in the amount of \$29,011.00 plus interest at the rate of 6% per annum from February 8, 2006. (*Id.* at 3.) The NASD Panel specifically denied Plaintiffs' request for punitive damages. (*Id.*) Because there are

³Plaintiffs asserted their unsuitability and breach of duty of good faith and fair dealing claims in the NASD Complaint. The remaining claims were taken from the Claim Information Sheet, with the exception of the claim for "failure to supervise," which does not appear in either document.

no findings of fact or conclusions of law, the reader cannot even speculate as to the factual basis for the monetary award.

II. STANDARD OF REVIEW

The procedure for granting summary judgment is found in FED. R. CIV. P. 56(c), made applicable to this proceeding through FED. R. BANKR. P. 7056, which provides in part that:

The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.

FED. R. BANKR. P. 7056(c). Summary judgment is proper if there is no genuine issue of material fact, and the moving party is entitled to judgment as a matter of law. FED. R. CIV. P. 56(c); *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-23 (1986). A fact is material if it could affect the determination of the underlying action. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986); *Tennessee Department of Mental Health & Retardation v. Paul B.*, 88 F.3d 1466, 1472 (6th Cir. 1996). An issue of material fact is genuine if a rational fact-finder could find in favor of either party on the issue. *Anderson*, 477 U.S. at 248-49; *SPC Plastics Corp. v. Griffith (In re Structurlite Plastics Corp.)*, 224 B.R. 27 (B.A.P. 6th Cir. 1998). Thus, summary judgment is inappropriate "if the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Anderson*, 477 U.S. at 248.

In a motion for summary judgment, the movant bears the initial burden to establish an absence of evidence to support the nonmoving party's case. *Celotex*, 477 U.S. at 322; *Gibson v. Gibson (In re Gibson)*, 219 B.R. 195, 198 (B.A.P. 6th Cir. 1998). The burden then

shifts to the nonmoving party to demonstrate the existence of a genuine dispute. *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 590 (1992). The evidence must be viewed in the light most favorable to the nonmoving party. *Adickes v. S.H. Kress & Co.*, 398 U.S. 144, 158-59 (1970). However, in responding to a proper motion for summary judgment, the nonmoving party "cannot rely on the hope that the trier of fact will disbelieve the movant's denial of a disputed fact, but must 'present affirmative evidence in order to defeat a properly supported motion for summary judgment.'" *Street v. J.C. Bradford & Co.*, 886 F.2d 1472, 1476 (6th Cir. 1989) (quoting *Anderson*, 477 U.S. at 257). That is, the nonmoving party has an affirmative duty to direct the court's attention to those specific portions of the record upon which it seeks to rely to create a genuine issue of material fact. *Street*, 886 F.2d at 1479.

III. LAW

Section 523(a) provides several exceptions to the general rule that pre-petition debts are dischargeable under the Code. Plaintiff bears the burden of proving that a debt is excepted from discharge. *See Meyers v. Internal Revenue Service (In re Meyers)*, 196 F.3d 622, 624 (6th Cir. 1999) (*citing Grogan v. Garner*, 498 U.S. 279, 290-91, 111 S.Ct. 654, 661 (1991)) Exceptions to discharge are narrowly construed. *See id.* (*citing Grogan*, 498 U.S. at 286-87, 111 S.Ct. at 654).

A. Fraud

Section 523(a)(2) states in pertinent part:

(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 most cases, in order to except debt from discharge under § 523(a)(2)(A), a creditor must prove that: (1) the debtor obtained money through a material misrepresentation that, at the time the representation was made, 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) the reliance was the proximate cause

of the loss. *Longo v. McLaren (In re McLaren)*, 3 F.3d 958, 961 (6th Cir. 1993).

However, the Bankruptcy Appellate Panel of the Sixth Circuit Court of Appeals recognized in 2001 that the phrase "actual fraud" in § 523(a)(2)(A) is broader than misrepresentation and misleading omission. In *Mellon Bank v. Vitanovich (In re Vitanovich)*, 259 B.R. 873, 877 (6th Cir. BAP 2001), the Panel wrote, "When a debtor intentionally engages in a scheme to deprive or cheat another of property or a legal right, that debtor has engaged in actual fraud and is not entitled to the fresh start provided by the bankruptcy Code." *Id.* (internal citations omitted).

Like fraud based upon misrepresentation, a debtor's subjective intent at the time the debt is incurred is critical to proving actual fraud. *Id.*; *Accord Rembert v. AT&T Universal Card Services, Inc. (In re Rembert)*, 141 F.3d 277 (6th Cir. 1998) (debtor's subjective intent to defraud essential to nondischargeability claim under § 523(a)(2)(A)).

B. Willful and Malicious Injury

Section 523(a)(6) of the Bankruptcy Code provides that "a discharge under [the Bankruptcy Code] does not discharge an individual debtor from any debt . . . for willful and malicious injury by the debtor to another entity or to the property of another entity." 11 U.S.C. § 523 (West 2006).

The Supreme Court has held that only acts done with intent to cause injury, and not merely acts done intentionally, rise to the level of willful injury for the purposes of satisfying section

523(a)(6). *Kawaauhau v. Geiger*, 523 U.S. 57, 57-58, 118 S.Ct. 974, 975 (1998). In *Markowitz v. Campbell (In re Markowitz)*, 190 F.3d 455 (6th Cir. 1999), the Sixth Circuit expanded the definition of "willfulness" to include the debtor's subjective belief that the injury is "substantially certain to result" from his actions. *Id.* at 464.

A person acts maliciously when that person acts in conscious disregard of his or her duties or without just cause or excuse. See *Heyne v. Heyne (In re Heyne)*, 277 B.R. 364, 368 (Bankr. N.D. Ohio 2002) (citing *Murray v. Wilcox (In re Wilcox)*, 229 B.R. 411, 419 (Bankr. N.D. Ohio 1998)); see also *Abdel-Hak v. Saad (In re Saad)*, 319 B.R. 147, 156 (citing *Tinker v. Colwell*, 193 U.S. 473, 485-86, 24 S.Ct 505 (1904) (defining "malice" under § 17(a)(2) of the former Bankruptcy Act [now § 523(a)(6) as "a wrongful act, done without just cause or excuse") (internal quotation marks and citations omitted)).

As the requirements of the statute are set forth in the conjunctive, a creditor must establish both willfulness and malice in order to prevail in a section 523(a)(6) action. However, two bankruptcy courts in this district have recognized that, in the great majority of cases, the same factual events giving rise to a finding of willfulness will likewise be indicative of malice. *Superior Metal Products v. Martin (In re Martin)*, 321 B.R. 437, 442 (Bankr. N.D. Ohio 2004); *CMEA Title Agency v. Little (In re Little)*, 335 B.R. 376, 383 (Bankr. N.D. Ohio 2005) ("Although the 'willful' and 'malicious' requirements will be found concurrently in most

cases, the terms are distinct, and both requirements must be met under § 523(a)(6).") Both courts, however, acknowledge that the "malice" element requires "a heightened level of culpability transcending mere willfulness." *In re Martin*, 321 B.R. at 442, *In re Little*, 335 B.R. at 384.

C. Violations of Securities Laws

Section 523(a)(19) reads, in pertinent part:

(a) A discharge under 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt-

(19) that-

(A) is for-

(i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or

(ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and

(B) results from⁴-

⁴The Bankruptcy Abuse and Consumer Protection Act of 2005 ("BAPCPA") added the phrase "results, before, on or after the date on which the petition was filed from-" to § 523(a)(19)(B). Since Defendant petitioned this Court for relief prior to the effective date of BAPCPA, the new language is inapplicable to the instant case.

However, the legislative history of § 523(a)(19) instructs that the section should be applied "[t]o the maximum extent possible," and "to all existing bankruptcies." *Gibbons*, 289 B.R. at 593 (citing 148 Cong. Rec. § 7418 (July 26, 2002)). The *Gibbons* Court interpreted the "existing bankruptcies" language to include bankruptcy cases where the securities fraud action had been commenced prior to the adoption of the statute but was still pending on the date of the enactment. *Id.*

The liberal interpretation afforded to the former version of the statute by Congress and the courts alike indicates that it should include NASD cases pending prior to the filing of the bankruptcy petition. Furthermore, Defendant has not challenged the applicability of former § 523(a)(19)(B) to the facts in the instant case.

(i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding;

(ii) any settlement agreement entered by the debtor; or

(iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.

11 U.S.C. § 523(a)(19).

According to the legislative history, the purpose of section 523(a)(19), which was added to the Bankruptcy Code as part of the Sarbanes-Oxley Act of 2002, was to protect investors:

Current bankruptcy law may permit such wrongdoers to discharge their obligations under court judgments or settlements based on securities fraud and other securities violations. This loophole in the law should be closed to help defrauded investors recoup their losses and to hold accountable those who violate securities laws after a government unit or private suit results in a judgment or settlement against the wrongdoer.

Frost v. Civiello (In re Civiello), __ B.R. __, 2006 WL 2422710, *3 (Bankr. N.D. Ohio (August 15, 2006) (*citing* Pub. L. No. 107-204, 116 Stat. 745 (2002))); *see also Smith v. Gibbons (In re Gibbons)*, 289 B.R. 588, 592 (S.D. N.Y. 2003).

IV. ANALYSIS

In his first argument, Defendant contends that this Court agreed to abstain not only from the determination of liability for the alleged debts but also from any fact finding regarding the dischargeability of said debts. Defendant asserts that the parties agreed in the June 2 Order that only the legal issue of dischargeability remains to be determined by this Court. Based upon the

language of the June 2 Order and because the exact same facts alleged in the Adversary Complaint were alleged in the NASD Complaint, this Court agrees.

Of course, dischargeability determinations are the sole province of the bankruptcy court. *Brown v. Felsen*, 442 U.S. 127, 136, 99 S.Ct. 2205, 2211 (1979). The exclusive power to determine dischargeability was granted to bankruptcy courts by the 1970 Amendments to the Bankruptcy Code. *Spilman v. Harley*, 656 F.2d 224, 226 (6th Cir. 1981). However, there is nothing in the Bankruptcy Code or federal common law which prevents a bankruptcy court from abdicating its fact-finding role to a state judicial or federal administrative forum where, as here, the parties to the dischargeability proceeding have agreed to submit all of the factual determinations to a single forum.

In the June 2 Order, this Court "abstain[ed] from consideration" of the factual allegations underlying the First, Second, and Third Counts of the Adversary Complaint (Paragraphs seven (7) through forty-four (44)), as well as the factual allegations regarding alleged misrepresentations made by Defendant in the Fourth Count (Paragraphs forty-five (45) and forty-six (46)). The foregoing paragraphs represent all of the factual allegations upon which Plaintiffs' dischargeability claims are premised. To the extent that the parties agreed that this Court would abstain from considering all of the facts asserted in the Adversary Complaint, except for those factual allegations underlying the challenge to Defendant's general discharge in the Fourth Count, it is clear that the parties intended the NASD Panel to be the exclusive fact finder with regard to the nondischargeability claims.

Moreover, the factual allegations in the Adversary Complaint and the NASD Complaint are identical. For instance, the facts alleged in support of Plaintiffs' § 523(a)(2) claim were the same facts alleged to prove their misrepresentation claims before the NASD. Likewise, the facts alleged in support of Plaintiffs' § 523(a)(19) claim were the same facts alleged to prove their unsuitability claim. Because Plaintiffs alleged identical facts, and, therefore, carried identical evidentiary burdens in both forums, it is reasonable that the parties intended to litigate all of the factual issues before a single forum - *i.e.*, the NASD Panel.

Despite the fact that Plaintiffs agreed to submit all of the factual issues underlying their dischargeability claims to the NASD Panel, the NASD Panel did not reveal which facts provide the basis for Defendant's liability on the two debts. Therefore, Plaintiffs contend that they may re-litigate the factual issues previously tried before the NASD Panel.

To the contrary, the parties agreed to be bound by the factual findings of the NASD Panel, with the "results of the final determination [by the NASD Panel] to be reported to this Court." (June 2 Order, ¶ 1.) As a result, even though the NASD Panel provided no findings of fact, Plaintiffs are foreclosed from adducing additional evidence before this Court to prove their nondischargeability claims.

Simply stated, Plaintiffs, by stipulating to the June 2 Order, assumed the responsibility of requesting detailed findings of fact from the NASD Panel. There is no evidence before this Court that the NASD Panel's failure to provide written findings of fact in the

Award occurred in spite of such a request by Plaintiffs. In the event that the NASD Panel had acted in contravention of a request for detailed findings, the Court would have no choice but to develop a factual record in the bankruptcy court. However, the evidence currently before this Court reveals that the responsibility for the omission by the NASD Panel falls squarely on Plaintiffs, who carry the burden of proof in this case. See *Meyers, supra*.

In their Memorandum in Opposition, Plaintiffs contend that Defendant's abstention argument is rooted in the doctrines of collateral estoppel and *res judicata*. (Mem. in Opp. at 1.) ("[Defendant] implicitly argues that the doctrines of collateral estoppel and/or *res judicata* preclude this court from examining the facts to determine the dischargeability of the debt.") Because *res judicata* is not applicable in nondischargeability proceedings, see *McGee v. Marcum*, 2006 WL 1478519 *4 (6th Cir. (Ky.) May 23, 2006 (citing *Brown*, 442 U.S. at 132, 99 S. Ct. at 2210), and because the Award does not reveal which facts were "actually and directly litigated" and were "necessary to the final judgment," see *Gonzalez v. Moffit (In re Moffitt)*, 252 B.R. 916, 921 (6th Cir. B.A.P. 2000), Plaintiffs conclude that Defendant's abstention argument is contrary to law.

In fact, however, it is Plaintiffs' theory that Defendant's abstention argument is premised upon collateral estoppel and *res judicata* that is without merit. This Court does not rely upon the doctrines of *res judicata* or collateral estoppel in reaching the conclusion that Plaintiffs may not provide additional evidence before this Court in support of their nondischargeability claims. Plaintiffs are foreclosed from adducing evidence because they

agreed, in the June 2 Order, that the NASD would be the final arbiter of the facts underlying their nondischargeability claims.

Plaintiffs' reliance on *Holland v. Zimmerman (In re Zimmerman)*, 341 B.R. 77 (Bankr. N.D. Georgia 2006) is similarly misplaced. In *In re Zimmerman*, the debtor, a registered securities salesman and investment advisor, was sued by several investors who claimed that he had misrepresented the risk involved in certain investments. *Id.* at 78. However, unlike the instant case, the debtor in *In re Zimmerman* opposed the motion filed on behalf of investors to lift the automatic stay in order that the parties could proceed to arbitration before the NASD. *Id.* at 79. Here, both parties agreed not only that the NASD was the "appropriate forum to determine [the] securities claims," but also that this Court would abstain from considering the factual allegations underlying the nondischargeability claims. Therefore, the holding in *In re Zimmerman* is inapposite to the issue before this Court.

Having concluded that the parties agreed that the sole issue before this Court in the First, Second, and Third Counts of the Adversary Complaint is the legal determination of dischargeability, the Court finds that Plaintiffs cannot demonstrate that the debts at issue in this case are nondischargeable. Although Plaintiffs were awarded damages by the NASD Panel, there is no conceivable way to determine whether those damages were predicated upon fraud, willful and malicious injury, or securities violations, as opposed to the breach of contract, negligence, or other claims asserted in

the NASD Complaint.⁵ Therefore, Defendant's Motion for Partial Summary Judgment on the First, Second, and Third Counts in the Adversary Complaint is well taken.

An appropriate order shall enter.

HONORABLE KAY WOODS
UNITED STATES BANKRUPTCY JUDGE

⁵Despite the compensatory damages award, which was less than 20% of the compensatory damages alleged before the NASD Panel, Plaintiffs continue to profess that Defendant's "wanton investment scheme [which] occurred over a period of two years" is to blame "for the loss of over \$300,000.00 in [Plaintiffs'] retirement funds." Mem. in Opp. at 9 and 10. In fact, the reduction in damages supports the opposite conclusion. Had the NASD Panel found that Defendant engaged in a course of fraud or willful and malicious conduct throughout his relationship with Plaintiffs, the Panel would have likely rescinded the transactions and awarded to Plaintiffs all of the requested damages.

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO

IN RE:

DAVID E. COOK and
DIANA L. COOK,

Debtors.

ROBERT D. MILES, *et al.*,

Plaintiffs,

vs.

DAVID E. COOK,

Defendant.

CASE NUMBER 02-45430

ADVERSARY NUMBER 04-4029

THE HONORABLE KAY WOODS

O R D E R

For the reasons set forth in this Court's Memorandum Opinion entered this date, Defendant's Motion for Partial Summary Judgment is granted with respect to the First, Second and Third Counts in the Adversary Complaint. A final pre-trial conference is set for Tuesday, November 7, 2006 at 9:30 a.m.

IT IS SO ORDERED.

HONORABLE KAY WOODS
UNITED STATES BANKRUPTCY JUDGE