

**UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF FLORIDA
JACKSONVILLE DIVISION**

In re:

Case No. 05-4163-GLP
Chapter 7

RETO J. SCHNEIDER,

Debtor.

MARTHA A. MILLER, as Chapter 7
Trustee for the bankruptcy estate of
Baita Real Estate, Inc.,

Plaintiff,

vs.

Adv. No. 05-223

RETO J. SCHNEIDER,

Defendant.

**FINDINGS OF FACT AND
CONCLUSIONS OF LAW**

This proceeding is before the Court upon the complaint filed by Plaintiff, Martha A. Miller, as Chapter 7 Trustee for the bankruptcy estate of Baita Real Estate, Inc., against Defendant, Reto J. Schneider, seeking a determination that the debt owed by Defendant to the bankruptcy estate of Baita Real Estate, Inc., is non-dischargeable pursuant to 11 U.S.C. §§ 523(a)(2), 523(a)(4), and 523(a)(6). After a hearing held on December 14, 2006, the Court makes the following Findings of Fact and Conclusions of Law.¹

FINDINGS OF FACT

1. On January 11, 2002, certain creditors of Baita Real Estate, Inc. ("BREI"), filed an involuntary petition under Chapter 7 of the Bankruptcy Code, in the United States Bankruptcy Court for the Northern District of Georgia, Atlanta Division.

¹ The trial transcript consists solely of the testimony of Plaintiff's certified public accountant, Spence A. Shumway, who was tendered as an expert witness in forensic accounting. Additionally, although instructed to do so, Defendant's counsel failed to file a post-trial brief and proposed Findings of Fact and Conclusions of Law.

2. At all times relevant to this proceeding, the Defendant, Reto J. Schneider ("Defendant"), was an officer and director of BREI, which operated as a holding company that received income from real estate projects. (Tr. 27, 41). At the time the involuntary petition was filed, BREI had no employees, and functioned solely as a "flow-through for money." (Tr. 19-20).

3. BREI had three primary subsidiaries: (i) Baita International, LLC ("BIL"), which syndicated real estate in the United States to German investors; (ii) Agora Development, LLC ("Agora"), which developed shopping centers in North Carolina and Florida; and (iii) Baita Development Company ("BDC"), which developed a shopping center in Texas. (Tr. 27-28).

4. On January 2, 2003, the Bankruptcy Court for the Northern District of Georgia, Atlanta Division (the "Georgia Court"), entered an order for relief. On January 16, 2003, Plaintiff, Martha A. Miller ("Plaintiff"), was appointed Chapter 7 Trustee for the bankruptcy estate of BREI.

5. The period of time between the filing of the involuntary petition by BREI's creditors in January 2002, and the Georgia Court's order granting relief in January 2003, is known as "the Gap Year." (Tr. 17, 19). BREI was insolvent for the duration of the Gap Year. (Tr. 45).

6. The Georgia Court did not enter an order granting relief earlier due to Defendant's repeated representations to the court, his creditors, and the United States Trustee that he was "holding" approximately \$1.3 million to pay creditors upon the settlement of their claims. (Tr. 18-19).

7. Based on Defendant's representation, the court allowed him, the creditors, and the United States Trustee to engage in negotiations. During the course of the year-long negotiations that followed, Defendant repeatedly represented that he was still "holding" \$1.3 million to pay creditors' claims upon the conclusion of settlement negotiations. (Tr. 18-19, 22-23).

8. The \$1.3 million that Defendant represented he would hold for creditors of BREI were the proceeds of BDC's sale of the Texas Forum property, a shopping center located in Texas. Although BDC was the entity that actually owned an interest in the Texas Forum property, BREI was entitled to approximately \$1.3 million of the proceeds from the sale because it owned a 60% stake in BDC. (Tr. 17, 44).

9. Although Defendant received \$1.3 million from the sale of the Texas Forum property, BREI's bank account had a balance of less than \$1,000.00 by the time Plaintiff was appointed Chapter 7 Trustee. During the Gap Year, Defendant incrementally transferred nearly the entire \$1.3 million from BREI to subsidiaries he managed and/or controlled. The primary recipient of the proceeds derived from the Texas Forum sale was BIL, an insolvent entity that Defendant was an officer and director of. (Tr. 18, 20, 26); (Pl. Exs. 4, 26).

10. BREI received no consideration for the transfers of the Texas Forum funds to BIL and other entities.

11. BREI's creditors received none of the proceeds derived from the sale of the Texas Forum property. (Tr. 19, 26).

12. The funds derived from the sale of the Texas Forum property would have been property of the bankruptcy estate, available to BREI's creditors, had Defendant not diverted the proceeds to BIL and other entities that he managed and/or controlled. (Tr. 44).

13. Additionally, during the Gap Year one of BREI's primary subsidiaries, Agora, was developing a project in Florida, called "Ranch Lake." Agora received "development fees" as the project progressed towards completion. At some point during the Gap Year, Defendant began diverting the Ranch Lake development fees from Agora to BIL. (Tr. 32-33); (Pl. Exs. 5-6).

14. Defendant funneled over \$100,000 of Agora's fees to BIL. (Tr. 34); (Pl. Exs. 5-6). BREI owned an 85% interest in Agora.

15. Agora and BIL were "brother-sister" limited liability companies, with no ownership interest in each other. Defendant never informed Plaintiff, creditors, or anyone else that he was funneling Agora's fees to BIL. (Tr. 32-33).

CONCLUSIONS OF LAW

The issue presently before the Court for its determination is whether the debt owed by Defendant to the bankruptcy estate of BREI in the amount of \$1,359,881.73 is non-dischargeable, pursuant to 11 U.S.C. §§ 523(a)(2), 523(a)(4), and 523(a)(6).

A. 523(a)(2) Analysis

11 U.S.C. § 523 sets forth the exceptions to a debtor's discharge; specifically, § 523(a)(2)(A) provides:

(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;

The Eleventh Circuit has previously stated that, "[i]n order to preclude the discharge of a particular debt because of a debtor's false representation, a creditor must prove that:

(i) the debtor made a false representation with the purpose and intention of deceiving the creditor;

(ii) the creditor relied on such representation;

(iii) his reliance was reasonably founded; and

(iv) the creditor sustained a loss as a result of the representation."

In re Hunter, 780 F.2d 1577, 1579 (11th Cir. 1986).

In a subsequent decision, the Eleventh Circuit adopted "justifiable reliance" as the standard of reliance a creditor must satisfy under § 523(a)(2), to prevent the discharge of a debt.² In re Vann, 67 F.3d 277, 281-284 (11th Cir. 1995). In order to constitute justifiable reliance, "the plaintiff's conduct must not be so utterly unreasonable, in light of the information apparent to him, that the law may properly say that his loss is his own responsibility." Id. at 283. However, in the absence of an "obvious reason" for investigation, justifiable reliance imposes no duty on the plaintiff to verify the defendant's representations. In re Brandon, 297 B.R. 308, 315 (Bankr. S.D. Ga. 2002).

² Further, the court stated, "[a]lthough the plaintiff's reliance on the misrepresentation must be justifiable, ... this does not mean that his conduct must conform to the standard of the reasonable man." In re Vann, 67 F.3d at 283.

In order to preclude the discharge of a debt due to a debtor's false pretenses, the creditor must show that the debtor made an "implied misrepresentation or [engaged in] conduct intended to create and foster a false impression." *Id.* at 313. Georgia courts have held that silence, or concealment of a material fact, can amount to an implied misrepresentation. *Id.* Finally, a debtor engages in actual fraud, in violation of § 523(a)(2), if he/she makes "a false or misleading representation with the intent to induce reliance and the plaintiff detrimentally relie[s] on the representation." *Id.*

I. BREI

Plaintiff argues that, during the Gap Year, Defendant obtained and secretly diverted approximately \$1.3 million from the BREI estate by making false representations to her, in her capacity as the Chapter 7 Trustee, the Court, and creditors. Plaintiff claims that Defendant, as an officer and director of BREI, obtained \$1.3 million from the sale of the Texas Forum property, and that he diverted the funds while engaging in negotiations with her and creditors, in an attempt to settle outstanding claims. Plaintiff maintains that the proceeds from the Texas Forum sale would have been part of the BREI estate had Defendant not improperly diverted them.

In support of her position, Plaintiff points out that Defendant admitted to receiving approximately \$1.3 million from the Texas Forum sale, yet by the time she was appointed Chapter 7 Trustee, BREI's bank account had a balance of less than \$1,000.00. Additionally, Plaintiff asserts that she, BREI's creditors, and the Georgia Court relied on Defendant's repeated representations that he would maintain the funds for creditors' claims. As evidence of her and BREI's creditors' reliance, Plaintiff claims that the reason no order for relief was entered during the Gap Year was because Defendant represented to the court and creditors that he was negotiating in good-faith and would preserve the Texas Forum funds for their claims. Finally, Plaintiff highlights the fact that BREI received no consideration for the diverted funds; consequently, BREI's creditors received none of the proceeds from the Texas Forum sale.

The Court agrees with the arguments set forth by Plaintiff, and finds that Defendant wrongfully obtained and diverted the proceeds from the Texas Forum sale, in violation of 11 U.S.C. § 523(a)(2)(A). It is undisputed that Defendant made repeated false representations to Plaintiff, his creditors, and the court, as evidenced by the fact that less than \$1,000.00 dollars of the initial \$1.3 million

remained in BREI's bank account at the end of the Gap Year. (Tr. 18, 22-23, 26). As the Defendant offered no legitimate explanation for his misrepresentations regarding the status of the Texas Forum funds, the Court finds that he obtained and diverted the funds by repeatedly making false representations with the intention to deceive creditors. Further, the Court finds that BREI's creditors relied on Defendant's false representations, as shown by the fact that they continued to voluntarily negotiate with him for nearly a year, while believing that he would preserve the Texas Forum funds. (Tr. 17, 19, 22). Additionally, based on the record before the Court, it cannot be said that Plaintiff had an "obvious reason" for investigating the Defendant's statements. Nothing in the record indicates that Plaintiff or BREI's creditor's possessed information that would have led to the discovery that Defendant's statements were false. Finally, the Court finds that BREI's creditors unquestionably sustained a loss due to the Defendant's repeated misrepresentations, as the funds wrongfully diverted would have been part of the BREI estate.

II. Agora

Plaintiff further argues that Defendant violated § 523(a)(2) by covertly funneling Agora's development fees to BIL. Plaintiff points out that, during the Gap Year, Agora was developing a project in Florida, named Ranch Lake. Plaintiff claims that Agora earned "development fees" during the course of the Ranch Lake project. However, Plaintiff asserts that Defendant began covertly funneling Agora's development fees (from the Ranch Lake project) to BIL. Plaintiff highlights the fact that BREI owned an 85% interest in Agora, and that Agora and BIL had no ownership interest in each other; instead, they were "brother-sister" limited liability companies. Thus, Plaintiff claims that Defendant, in his capacity as an officer of BREI and BIL, wrongfully obtained Agora's development fees through false pretenses.

In support of her position, Plaintiff asserts that Defendant deliberately concealed the fact that he was funneling Agora's fees to BIL, even though he was aware that she and creditors were under the false impression that the Ranch Lake development fees were properly being paid to Agora. Consequently, Plaintiff claims that Defendant's failure to disclose the material fact that he was diverting Agora's development fees to BIL, constituted an implied misrepresentation. Finally, Plaintiff maintains that Defendant's implied misrepresentation, regarding the diversion of Agora's fees, created a false impression that Agora was receiving the Ranch Lake development fees.

The Court agrees with Plaintiff's argument that Defendant violated § 523(a)(2)(A) by covertly funneling Agora's development fees to BIL, during the Gap Year. (Tr. 32-33); (Pl. Exs. 5-6). As the Defendant offered no explanation for his actions, the Court finds that he purposefully failed to inform Plaintiff and creditors of the material fact that he was funneling Agora's fees to BIL. The Court further finds that Defendant's failure to disclose the diversion of Agora's development fees to BIL, created a false impression that Agora was actually receiving such fees. As BREI owned an 85% stake in Agora, the Court finds that Plaintiff and BREI's creditors sustained a substantial financial loss due to Defendant's conduct.

Accordingly, the Court finds that the debt Defendant owes to the bankruptcy estate of BREI, in the amount of \$1,359,881.73, is non-dischargeable pursuant to 11 U.S.C. § 523(a)(2)(A).

B. 523(a)(4) Analysis

11 U.S.C. § 523(a)(4) 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 ---
- (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

In Quaif, the Eleventh Circuit analyzed the concept of defalcation³ by a fiduciary when confronted with the case of an insurance agent who misappropriated funds, and was subject to a Georgia statute which provided: "All funds representing premiums received or return premiums due the insured by any agent,.... shall be accounted for in his fiduciary capacity, shall not be commingled with his personal funds, and shall be promptly accounted for and paid to the insurer, insured, or agent as entitled to such funds." Quaif v. Johnson, 4 F.3d 950, 952-955 (11th Cir. 1993). The bankruptcy court had previously determined that for the purposes of § 523(a)(4), the statutory language established that the

³ The Court in Quaif stated that "defalcation" refers to "a failure to produce funds entrusted to a fiduciary." 4 F.3d at 955. The Court further asserted that "while a purely innocent mistake by the fiduciary may be dischargeable, a 'defalcation' for purposes of [section 523(a)(4)] does not have to rise to the level of fraud, embezzlement, or even misappropriation." Id.

insurance agent owed a fiduciary duty to his creditor, the insurer. Quaif, 4 F.3d at 952-953. The insurance agent argued that no fiduciary relationship had been created between himself and his creditor. Id.

After the United States District Court for the Northern District of Georgia affirmed the bankruptcy court's determination, the Eleventh Circuit reviewed the case, taking into account Supreme Court precedent which held that the term "fiduciary" should not be broadly construed; rather, it was intended to refer to technical trusts only. Id. at 952-954; see Davis v. Aetna Acceptance Co., 293 U.S. 328 (1934). The Eleventh Circuit explained that traditionally trusts fell into one of two categories: (i) voluntary trusts created by contract (express trusts), or (ii) trusts created by the operation of law, such as constructive or resulting trusts. Id. at 953. The court stated that historically only express trusts were within the scope of "fiduciary capacity," as used in § 523(a)(4). Id. The court further stated that traditionally constructive and resulting trusts did not fall within the scope of the discharge exception because "the act which created the debt simultaneously created the trust relationship," in violation of the requirement that the trust relationship must pre-date the act of defalcation. Id. The court then recognized that fiduciary duties could also be created by statutorily-created trusts, "dependent upon the relationship between the parties." Id. Finally, the Eleventh Circuit concluded that the Georgia statute created a pre-existing fiduciary duty, which the agent violated, since the statute required him to keep the premiums collected on the insurer's behalf separate from other funds, and account for such funds, yet he failed to do so. Id. at 954-955.

In a case subsequent to Quaif, a bankruptcy court in the Southern District of Georgia addressed the issue of whether an officer of a bankrupt corporation breached a fiduciary duty owed to creditors by using corporate funds for her own personal benefit, after the corporation filed for Chapter 7 relief. In re Pharr-Luke, 259 B.R. 426, 430-431 (Bankr. S.D. Ga. 2000). The court in Pharr-Luke noted that that the only "meaningful distinction" between the facts of the case before it and the Quaif case was that, "the fiduciary duty created here is one imposed by common law rather than statute, [as in Quaif]." Id. at 431. The court stated that in regard to § 523(a)(4), under Georgia law, "managing officers [and directors] of a corporation are charged with the duty of conserving and managing the remaining assets in trust for the

creditors when the corporation becomes insolvent.”⁴ Id. at 430; (citing Ware v. Rankin, 97 Ga. App. 837, 838 (Ga. Ct. App. 1958)). Thus, “[w]hen a corporation becomes insolvent its directors are bound to manage the remaining assets for the benefits of its creditors, and cannot in any manner use their powers for the purpose of obtaining a preference or advantage to themselves.” Id.; (citing Ware, 97 Ga. App. at 838).

In reaching its holding, the court reasoned that the distinction between fiduciary duties imposed by statute, and those imposed by the common law, was immaterial as applied to § 523(a)(4). In re Pharr-Luke, 259 B.R. at 431. Specifically, the court found that Georgia common law imposed an express, pre-existing fiduciary duty on the officer to conserve and manage the insolvent corporation’s remaining assets in trust for its creditors. Id. at 430-431; see Ware, 97 Ga. App. at 838. The court then held that the officer breached the fiduciary duty she owed to creditors by using the insolvent corporation’s funds “for personal and business gain,” post-petition;⁵ therefore, the court excepted those funds from the officer’s discharge pursuant to 11 U.S.C. § 523(a)(4). Id. at 432.

Plaintiff argues that the Defendant, as an officer and director of BREI, violated the Georgia common law fiduciary duty he owed to BREI’s creditors by transferring virtually all of the proceeds related to the Texas Forum sale from BREI to BIL (and other affiliated subsidiaries owned or controlled by him), after BREI had become insolvent. Plaintiff further asserts that Defendant obtained an advantage for himself, in violation of his fiduciary duty to BREI’s creditors, by transferring the funds in question to BIL and other subsidiaries that he owned or controlled. Thus, the crux of Plaintiff’s argument is that Defendant’s discharge should be denied for defalcation of the Texas Forum funds, as he owed a fiduciary duty to BREI’s creditors when he wrongfully diverted the funds, because BREI was insolvent at the time.

⁴ A corporation will be considered insolvent if “after a deed or conveyance, the property left or retained by the debtor is not ample to pay his existing debts.” In re Pharr-Luke, 259 B.R. at 431-432.

⁵ The court in Pharr-Luke stated that from the moment the corporation filed for Chapter 7 relief, the officer “had a fiduciary to manage the assets of the insolvent corporation ... for the benefit of its creditors and avoid misuse of those assets.” 259 B.R. at 432.

In support of her position, Plaintiff argues that the fiduciary duty Defendant owed to BREI’s creditors existed prior to his acts of defalcation. Plaintiff points out that BREI was insolvent prior to the time Defendant diverted the Texas Forum funds, and therefore, she argues that he was under a pre-existing fiduciary duty to BREI’s creditors, to manage such funds for their benefit. Plaintiff claims that Defendant’s conduct constitutes defalcation because the Texas Forum proceeds were entrusted to him in his fiduciary capacity, as an officer of BREI, and he failed to manage and produce those funds for BREI’s creditors once it became insolvent. See Id. at 430; (citing Ware, 97 Ga. App. at 838). Finally, Plaintiff argues that Defendant intentionally “stripped” BREI of all its assets during insolvency by covertly transferring them to entities he owned or controlled, leaving creditors without recourse.

The Court agrees with Plaintiff’s argument that Defendant breached the fiduciary duty imposed on him by Georgia common law which provides that, “[w]hen a corporation becomes insolvent its directors are bound to manage the remaining assets for the benefits of its creditors, and cannot in any manner use their powers for the purpose of obtaining a preference or advantage to themselves.” In re Pharr-Luke, 259 B.R. at 430; (citing Ware, 97 Ga. App. at 838). Additionally, the Court finds that Defendant breached a *pre-existing* fiduciary duty owed to BREI’s creditors, as the company was insolvent at all relevant times, and therefore, the trust relationship pre-dated the acts of defalcation. See In re Quaif, 4 F.3d at 953. Further, Defendant obtained an advantage for himself, in violation of his duty to BREI’s creditors, by transferring the Texas Forum proceeds to BIL and other affiliates, despite his knowledge that both entities were insolvent and BREI was the rightful recipient of such funds. (Tr. 44-45). As a result, the Court finds that the debt Defendant owes to the bankruptcy estate of BREI is non-dischargeable, pursuant to 11 U.S.C. § 523(a)(4).

As the Court has already determined that Defendant is not entitled to discharge the debts owed to the bankruptcy estate of BREI, pursuant to 11 U.S.C. §§ 523(a)(2)(A) and 523(a)(4), Plaintiff’s additional arguments under § 523(a)(6) need not be addressed.

CONCLUSION

Based on the above, the debt owed by Defendant to the bankruptcy estate of BREI, in the amount of \$1,359,881.73, is non-dischargeable pursuant to 11 U.S.C. §§ 523(a)(2)(A) and 523(a)(4). The Court will enter a separate order consistent with these Findings of Fact and Conclusions of Law.

ORDERED on June 5, 2007, in Jacksonville, Florida.

/s/ George L. Proctor
George L. Proctor
United States Bankruptcy Judge

Copies to:

Plaintiff
Defendant
Richard R. Thames
Chapter 7 Trustee
United States Trustee