SO ORDERED.
SIGNED this 13th day of September, 2019

Suzanne H. Bauknight
UNITED STATES BANKRUPTCY JUDGE

THIS ORDER HAS BEEN ENTERED ON THE DOCKET.
PLEASE SEE DOCKET FOR ENTRY DATE.

IN THE UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF TENNESSEE

In re

Case No. 3:18-bk-33042-SHB
Chapter 7

CONRAD MARK TROUTMAN
fdba TROUTMAN & TROUTMAN

Debtor

JERRY FAERBER, and wife,
MARGARET FAERBER

Plaintiffs

v.

Adv. Proc. No. 3:19-ap-3001-SHB

CONRAD MARK TROUTMAN

Defendant

MEMORANDUM AND ORDER ON
MOTION TO DISMISS ADVERSARY COMPLAINT

On January 7, 2019, Plaintiffs filed the Complaint for Determination of Dischargeability Pursuant to Section 523 of the Bankruptcy Code ("Complaint") to commence this adversary proceeding that asks the Court to determine that a judgment entered in their favor against

Defendant is nondischargeable under 11 U.S.C. § 523(a)(2)(A) and/or (a)(4). [Doc. 1.] Defendant filed a Motion to Dismiss Adversary Complaint ("Motion to Dismiss") and brief in support on April 19, 2019 [Docs. 11, 12], seeking dismissal under Federal Rule of Civil Procedure 12(b)(6).[1] Plaintiffs timely responded in opposition to the Motion to Dismiss in accordance with E.D. Tenn. LBR 7007-1(a).[2] [Docs. 13, 14.]

Rule 12(b)(6) requires dismissal for "failure to state a claim upon which relief can be granted." Fed. R. Civ. P. 12(b)(6). "A pleading that states a claim for relief must contain: (1) a short and plain statement of the grounds for the court's jurisdiction . . . ; (2) a short and plain statement of the claim showing that the pleader is entitled to relief; and (3) a demand for the relief sought, which may include relief in the alternative or different types of relief." Fed. R. Civ. P. 8(a).[3] When fraud is alleged, Rule 8 is read in conjunction with Rule 9(b),[4] which requires that fraud be pled with particularity so that the defendant has sufficient notice of the alleged misconduct. *U.S. ex rel. Bledsoe v. Cmty. Health Sys., Inc*., 501 F.3d 493, 503 (6th Cir. 2007) (requiring that, "at a minimum, [the complaint] must 'allege the time, place, and content of the alleged misrepresentation on which he or she relied; the fraudulent scheme; the fraudulent intent of the defendants; and the injury resulting from the fraud'" (quoting *Coffey v. Foamex L.P.*, 2 F.3d 157, 161-62 (6th Cir. 1993))).

[1] Rule 12 is applicable in adversary proceedings under Rule 7012(b) of the Federal Rules of Bankruptcy Procedure.

[2] In their response, Plaintiffs correctly state that the Motion to Dismiss does not include the passive notice legend required by E.D. Tenn. LBR 7007-1(c) and ask the Court to deny the Motion to Dismiss, in part, for that reason. Although the Court agrees that the Local Rules must be followed, because Plaintiffs filed a response within the twenty-one-day objection period and, thus, were not prejudiced by Defendant's failure to include the passive notice legend, the Court deems the passive notice requirement "waived" and will not deny the Motion to Dismiss solely on Defendant's non-compliance with LBR 7007-1(c).

[3] Rule 8 is applicable in adversary proceedings under Rule 7008 of the Federal Rules of Bankruptcy Procedure.

[4] Rule 9 is applicable in adversary proceedings under Rule 7009 of the Federal Rules of Bankruptcy Procedure.

"To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'" *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007)). The complaint need not contain "detailed factual allegations[; however,] a plaintiff's obligation to provide the grounds of his 'entitle[ment] to relief' requires more than labels and conclusions, and a formulaic recitation of a cause of action's elements will not do. Factual allegations must be enough to raise a right to relief above the speculative level[.]" *Twombly*, 550 U.S. at 545.

> [Although] a complaint will survive a motion to dismiss if it contains "either direct or inferential allegations respecting all material elements" necessary for recovery under a viable legal theory, [the] court "need not accept as true legal conclusions or unwarranted factual inferences, and conclusory allegations or legal conclusions masquerading as factual allegations will not suffice."

Philadelphia Indem. Ins. Co. v. Youth Alive, Inc., 732 F.3d 645, 649 (6th Cir. 2013) (quoting *Terry v. Tyson Farms, Inc*., 604 F.3d 272, 275-76 (6th Cir. 2010)).

> A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged. The plausibility standard is not akin to a "probability requirement," but it asks for more than a sheer possibility that a defendant has acted unlawfully. Where a complaint pleads facts that are "merely consistent with" a defendant's liability, it "stops short of the line between possibility and plausibility of 'entitlement to relief.'"

Iqbal, 556 U.S. at 678 (quoting *Twombly*, 550 U.S. at 556-57).

When deciding whether to dismiss under Rule 12(b)(6), the court "construe[s] the complaint in the light most favorable to the plaintiff, accept[s] its allegations as true, and draw[s] all reasonable inferences in favor of the plaintiff." *Bassett v. Nat'l Collegiate Athletic Ass'n*, 528 F.3d 426, 430 (6th Cir. 2008) (quoting *Directv, Inc. v. Treesh*, 487 F.3d 471, 476 (6th Cir. 2007)). The Court also "'consider[s] the complaint in its entirety, as well as . . . documents incorporated into the complaint by reference, and matters of which a court may take judicial

notice.'" *Solo v. United Parcel Serv. Co*., 819 F.3d 788, 794 (6th Cir. 2016) (alteration in original) (quoting *Tellabs, Inc. v. Makor Issues & Rights, Ltd*., 551 U.S. 308, 322 (2007)).

Here, the Complaint alleges that a $76,083.00 judgment awarded to them on June 3, 2016, by the Campbell County Circuit Court ("Circuit Judgment")[5] is nondischargeable because Defendant made false representations to Plaintiffs in connection with Plaintiffs' real estate purchase in August 2010 and breached the fiduciary relationship he had with Plaintiffs by failing to procure title insurance and releasing their funds to the seller without authorization or consent. [Doc. 1 at ¶¶ 6, 18, 20, 25-26, 30, 32, Exs. 1-2, 5, 7.] Defendant responds by acknowledging entry of the Judgment against him, but he argues that Plaintiffs are collaterally estopped from asserting facts that were previously decided by the Circuit Court and the Court of Appeals and that Plaintiffs have not pleaded sufficient facts to support a determination that the Judgment is nondischargeable under either 11 U.S.C. § 523(a)(2)(A) or (a)(4). [Doc. 11 at ¶¶ 7, 9.]

Even accepting all allegations as true and in a light most favorable to Plaintiffs, because the Circuit Court, as affirmed by the Court of Appeals, expressly determined that Defendant was not liable for fraudulent misrepresentation, Tennessee law of collateral estoppel would bar Plaintiffs from relitigating their fraud claim in state court. Thus, Count I of their Complaint, seeking a determination of nondischargeability under 11 U.S.C. § 523(a)(\2)(A), is barred by collateral estoppel so that Count I must be dismissed. Regarding Count II, however, taking all allegations in a light most favorable to Plaintiffs, the Complaint pleads facts sufficient to maintain a cause of action under 11 U.S.C. § 523(a)(4).

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[5] The state court case was styled *Jerry Faerber and wife, Margaret Faerber v. Troutman & Troutman, P.C.; Mark Troutman; Thor Industries, LLC; Wilrite, LLC; Steve Williams; and Teresa Montgomery,* No. 15495. The Circuit Judgment was reversed in part and affirmed in part by the Tennessee Court of Appeals ("Court of Appeals"), in *Faerber et al. v. Troutman & Troutman, P.C., et al*, No. E2016-01378-COA-R3-CV ("Appellate Judgment") on June 22, 2017. Unless otherwise specifically identified, all references to "the Judgment" will refer to the Circuit Judgment and the Appellate Judgment collectively.

I. COLLATERAL ESTOPPEL

Defendant argues that the Complaint should be dismissed because collateral estoppel bars Plaintiffs from asserting any new or additional facts concerning the Judgment. [*See* Doc. 12 at ¶¶ 4, 6.] As applied in Tennessee, the doctrine of collateral estoppel "bars the same parties or their privies from relitigating in a later proceeding legal or factual issues that were actually raised and necessarily determined in an earlier proceeding . . . [so] that [such] determination is conclusive against the parties in subsequent proceedings." *Mullins v. State*, 294 S.W.3d 529, 534-35 (Tenn. 2009). Collateral estoppel applies "to issues of law and to issues of fact." *Gibson v. Trant*, 58 S.W.3d 103, 113 (Tenn. 2001); *see also Booth v. Kirk*, 381 S.W.2d 312, 315 (Tenn. Ct. App. 1963) ("[M]aterial facts or questions, which were in issue in a former action and were there admitted or judicially determined, are conclusively settled by a judgment rendered therein, and . . . such facts or questions become res judicata and may not again be litigated in a subsequent action *between the same parties*." (citation omitted)).

Although the Supreme Court has held that claim preclusion does not apply to dischargeability actions, it has expressly explained that issue preclusion – or collateral estoppel – does apply in nondischargeability actions. *See Grogan v. Garner*, 498 U.S. 279, 284-85 (1991) ("If the preponderance standard also governs the question of nondischargeability, a bankruptcy court could properly give collateral estoppel effect to those elements of the claim that are identical to the elements required for discharge and which were actually litigated and determined in the prior action.").

> [The collateral estoppel] doctrine holds that "[w]hen an issue of ultimate fact has been determined by a valid judgment, that issue cannot be again litigated between the same parties." Black's Law Dictionary 260 (6th ed. 1990). "The purposes of collateral estoppel are to shield litigants (and the judicial system) from the burden of re-litigating identical issues and to avoid inconsistent results."

NCM Enters. Sand & Stone, Ltd. v. Earnest (In re Earnest), No. 11-36044, 2013 WL 795399, at *3 (Bankr. N.D. Ohio Mar. 1, 2013) (quoting *Gilbert v. Ferry*, 413 F.3d 578, 580 (6th Cir. 2005)).

> In Tennessee, the doctrine of collateral estoppel requires the following proof:
>
> > (1) that the issue sought to be precluded is identical to an issue decided in an earlier proceeding; (2) that the issue sought to be precluded was actually raised, litigated, and decided on the merits in the earlier proceeding; (3) that the judgment in the earlier proceeding has become final; (4) that the party against whom collateral estoppel is asserted was a party or is in privity with a party to the earlier proceeding; and (5) that the party against whom collateral estoppel is asserted had a full and fair opportunity in the earlier proceeding to contest the issue now sought to be precluded.

Mullins, 294 S.W.3d at 535. The party asserting collateral estoppel bears "the burden of proving that the issue was, in fact, determined in a prior suit between the same parties and that the issue's determination was necessary to the judgment." *Dickerson v. Godfrey*, 825 S.W.2d 692, 695 (Tenn. 1992). Additionally, when a plaintiff in the earlier proceeding is the party to be precluded, "it is appropriate to consider (1) the procedural and substantive limitations placed on the plaintiff in the first proceeding, (2) the plaintiff's incentive to litigate the claim fully in the first proceeding, and (3) the parties' expectation of further litigation following the conclusion of the first proceeding." *Mullins*, 294 S.W.3d at 538-39.

II. 11 U.S.C. § 523(a)(2)(A)

To the extent obtained by false pretenses, false representations, or actual fraud, a debt may be excepted from discharge by § 523(a)(2)(A). Courts construe § 523(a) actions liberally in favor of debtors and strictly against creditors, who bear the burden of proving the necessary elements by a preponderance of the evidence. *Grogan*, 498 U.S. at 291 (1991); *Rembert v. AT&T Universal Card Servs., Inc. (In re Rembert)*, 141 F.3d 277, 281 (6th Cir. 1998). To satisfy the statutory elements, Plaintiffs must prove that Defendant obtained money from or belonging to

them through material misrepresentations that Defendant knew were false or were made with gross recklessness, that Defendant intended to deceive Plaintiffs, that Plaintiffs justifiably relied on Defendant's false representations, and that Plaintiffs' reliance was the proximate cause of their losses. *McDonald v. Morgan (In re Morgan)*, 415 B.R. 644, 649 (Bankr. E.D. Tenn. 2009). "In the context of § 523(a)(2)(A), 'false representations and pretense encompass statements that falsely purport to depict current or past facts." *Almasudi v. Ibrahim (In re Ibrahim)*, 580 B.R. 218, 234 (Bankr. E.D. Tenn. 2017) (quoting *Peoples Sec. Fin. Co. v. Todd (In re Todd)*, 34 B.R. 633, 635 (Bankr. W.D. Ky. 1983)); *see also Haney v. Copeland (In re Copeland)*, 291 B.R. 740, 761 (Bankr. E.D. Tenn. 2003) (stating that material misrepresentations under § 523(a) are "substantial inaccuracies of the type which would generally affect a lender's or guarantor's decision." (quoting *Candland v. Ins. Co. of N. Am. (In re Candland)*, 90 F.3d 1466, 1470 (9th Cir. 1996))). Nevertheless, "[f]raudulent intent requires an actual intent to mislead, which is more than mere negligence." *In re Copeland*, 291 B.R. at 766 (citations omitted).

As it relates to this adversary proceeding and the elements necessary for a determination of nondischargeability under § 523(a)(2)(A), the Judgment's factual findings on the claim of fraudulent or intentional misrepresentation control here because proof of fraudulent or intentional misrepresentation under Tennessee law is substantially similar to the proof required under § 523(a)(2)(A). *See Gray v. Vinsant (In re Vinsant)*, 539 B.R. 351, 359 (Bankr. E.D. Tenn. 2015).

> To recover for intentional misrepresentation, a plaintiff must prove: (1) that the defendant made a representation of a present or past fact; (2) that the representation was false when it was made; (3) that the representation involved a material fact; (4) that the defendant either knew that the representation was false or did not believe it to be true or that the defendant made the representation recklessly without knowing whether it was true or false; (5) that the plaintiff did not know that the representation was false when made and was justified in relying on the truth of the representation; and (6) that the plaintiff sustained damages as a result of the representation.

Hodge v. Craig, 382 S.W.3d 325, 343 (Tenn. 2012) (citing *Walker v. Sunrise Pontiac-GMC Truck, Inc.*, 249 S.W.3d 301, 311 (Tenn. 2008), *quoted with approval in* the Judgment [Doc. 1, Ex. 5 at ¶ B.7]). On the other hand,

> the essential elements of a claim for negligent misrepresentation are: (1) the defendant was acting in the course of its business or profession or in a transaction in which it had a pecuniary interest; (2) the defendant supplied faulty information meant to guide others in their business transactions; (3) the defendant failed to exercise reasonable care in obtaining or communicating the information; and (4) the plaintiff justifiably relied upon the information.

Pritchett v. Comas Montgomery Realty & Auction Co., Inc., No. M2014-00583-COA-R3-CV, 2015 WL 1777445, at *3 (Tenn. Ct. App. Apr. 15, 2015); [*see also* Doc. 1, Ex. 7 at ¶ B.1].

As evidenced by the Circuit Judgment, Plaintiffs raised and litigated the following causes of action: negligent misrepresentation, fraudulent misrepresentation, breach of contract, legal malpractice, and Tennessee Consumer Protection Act violations (including whether to assess punitive damages and award attorneys' fees) in their lawsuit against Defendant in the Circuit Court. [Doc. 1, Ex. 5.] The Circuit Judgment stated that Defendant and his law firm were "liable for negligent misrepresentation and violation of the Tennessee Consumer Protection Act," [Doc. 1, Ex. 5 at ¶ C.1.], and expressly found that "Defendants [we]re not liable for fraudulent misrepresentation." [*Id*.] The Appellate Judgment reversed the Circuit Court's ruling that Defendants were liable to Plaintiffs under the Tennessee Consumer Protection Act (thus reversing the Circuit Court's award of attorneys' fees and costs); however, the Court of Appeals otherwise expressly affirmed the decision of the Circuit Court, including the rulings concerning negligent and fraudulent misrepresentation. [*See* Doc. 1, Ex. 7 at 13.]

Accordingly, applying the *Mullins* collateral estoppel elements to the § 523(a)(2) action, the Court finds that the issue was raised, litigated, and decided on the merits by the Circuit Court

(and examined on appeal by the Court of Appeals); the parties are the same in both lawsuits; and Plaintiffs had a full and fair opportunity to fully litigate all issues and, in fact, did litigate all issues raised. Additionally, the Appellate Judgment, which was entered on June 22, 2017, and affirms the Circuit Court's decision concerning the relevant issue at hand, is a final order.

Because the Judgment expressly states that Defendant was not liable for fraudulent misrepresentation and the elements of negligent misrepresentation do not implicate the fraudulent behavior required for a determination of nondischargeability under § 523(a)(2)(A), and because the doctrine of collateral estoppel bars Plaintiffs from relitigating the "factual issues that were actually raised and necessarily determined in an earlier proceeding," *Mullins*, 294 S.W.3d at 534, Plaintiffs have not stated a claim upon which relief can be granted, and Count I of the Complaint must be dismissed.

III. 11 U.S.C. § 523(a)(4)

Nondischargeability under § 523(a)(4) requires a showing that the debt was incurred by embezzlement, larceny, or fraud or defalcation while acting in a fiduciary capacity. Here, Plaintiffs have alleged that Defendant committed fraud or defalcation while acting in a fiduciary capacity, which encompasses both embezzlement and larceny,[6] as well as the failure to properly account for funds. Such allegations may be the basis for a nondischargeable debt only if Plaintiffs can prove "(1) a pre-existing fiduciary relationship; (2) a breach of that relationship; and (3) resulting loss." *Patel v. Shamrock Floorcovering Servs., Inc. (In re Patel)*, 565 F.3d 963, 968 (6th Cir. 2009); *see also Bd. of Trs. of the Ohio Carpenters' Pension Fund v. Bucci (In re*

[6] Within the scope of § 523(a)(4), embezzlement is "the fraudulent appropriation of property by a person to whom such property has been entrusted or into whose hands it has lawfully come." *Brady v. McAllister (In re Brady)*, 101 F.3d 1165, 1172-73 (6th Cir. 1996). Larceny is also the fraudulent misappropriation of funds; however, it differs from embezzlement because possession of the property was never lawful. *See First Nat'l Bank v. Simerlein (In re Simerlein)*, 497 B.R. 525, 537 (Bankr. E.D. Tenn. 2013).

Bucci), 493 F.3d 635, 639 (6th Cir. 2007). This prong "includes a culpable state of mind requirement akin to that which accompanies application of the other terms in the same statutory phrase[:] . . . one involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior." *Bullock v. BankChampaign, N.A.*, 569 U.S. 267, 269 (2013).

The Sixth Circuit has long refused to extend a fiduciary relationship "to constructive or implied trusts imposed by operation of law as a matter of equity." *In re Bucci*, 493 F.3d at 639 (citing *Capitol Indem. Corp. v. Interstate Agency, Inc. (In re Interstate Agency, Inc.)*, 760 F.2d 121, 125 (6th Cir. 1985)). The failure to meet obligations under a common-law fiduciary relationship is not actionable under § 523(a)(4). *Id.* (citing *R.E. Am., Inc. v. Garver (In re Garver)*, 116 F.3d 176, 179 (6th Cir. 1997)). Instead, the relationship under § 523(a)(4) is found only in "those situations involving an express or technical trust relationship arising from placement of a specific res in the hands of the debtor." *In re Garver*, 116 F.3d at 180. Because the defalcation provision does not apply to constructive or implied trusts, "[t]o establish the existence of an express or technical trust, a creditor must demonstrate: '(1) an intent to create a trust; (2) a trustee; (3) a trust res; and (4) a definite beneficiary.'" *In re Bucci*, 493 F.3d at 640 (quoting *Commonwealth Land Title Co. v. Blaszak (In re Blaszak)*, 397 F.3d 386, 391-92 (6th Cir. 2005)).

Although the existence of a fiduciary relationship is determined by federal law, federal "courts look to state law in ascertaining whether an express or technical trust has been created." *See id.* at 390-91. Under Tennessee Rule of Professional Conduct 1.15,[7] attorneys must "hold

[7] Tennessee Rule of Professional Conduct 1.15(b)(2) also provides, "A lawyer shall deposit all funds of clients and third persons that are nominal in amount or expected to be held for a short period of time such that the funds cannot earn income for the benefit of the client or third persons in excess of the costs incurred to secure such income in or more pooled accounts known as "Interest on Lawyers' Trust Account" ("IOLTA"), in accordance with the requirements of Supreme Court Rule 43." Notably, the Tennessee Board of Professional Responsibility's release concerning the disbarment of Defendant (which is considered by the Court because it was exhibited to Plaintiffs'

property and funds of clients or third persons . . . in a separate account maintained in an FDIC member depository institution." Tenn. Sup. Ct. R. 8, RPC 1.15(a), -(b). Although it seems patently obvious that an attorney's "trust" account, in which the attorney must hold the funds of third parties as well as clients, is an express or technical trust, several courts have so held. *See, e.g., Szachta v. Thompson (In re Thompson)*, No. 15-04775, 2016 WL 1055582, *5 (Bankr. E.D. Mich. Sept. 15, 2017) ("Plaintiffs' settlement proceeds were required to be deposited in the IOLTA account, separate from money that belonged to the firm. This evidences an intent to create a trust. The settlement proceeds were the trust res, Plaintiffs were the beneficiaries, and [the debtor] was a trustee."); *Stallworth v. McBride (In re McBride)*, 512 B.R. 103, 113 (Bankr. D. Mass. 2014) (finding that although "not every breach of a fiduciary duty by an attorney will give rise to a nondischargeable debt, . . . an attorney may be considered to be acting in a fiduciary capacity for purposes of § 523(a)(4) if the attorney is entrusted with client funds or property"); *cf. Auburn Dev. Corp. v. Shorton* (*In re Shorton)*, 378 B.R. 424, 430 (Bankr. D. Mass. 2007) (stating, regarding a § 523(a)(4) action that "[t]he third party escrow agent becomes the fiduciary of both the depositor and the grantee . . . and has a duty to keep the deposit and can not dispose of it except pursuant to the terms of the underlying agreement."); *Montedonico v. Dichtel (In re Dichtel*), No. 97-0129, 1997 WL 34726865, at * (Bankr. W.D. Tenn. Aug. 15, 1997) ("[A]ll attorneys in the State of Tennessee must hold the property of clients in trust and that money should be clearly designated in a separate trust account.").

Plaintiffs' Complaint expressly includes allegations that Plaintiffs presented Defendant with funds (the trust res), that Defendant acted as a trustee in receiving such funds, that Plaintiffs were the beneficiaries of the trust; and that Defendant breached his fiduciary duty as trustee

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Complaint (*see Solo*, 819 F.3d at 794)) states that Defendant "violated Rule[] of Professional Conduct 1.15 (Safekeeping Property and Funds)." [Doc. 1-7.]

when he misappropriated the trust res by distributing the funds contrary to Plaintiffs' instructions. [Doc. 1 at ¶¶ 11-15.] Under Supreme Court and Sixth Circuit precedent, these factual averments are sufficient for Count II of the Complaint to withstand the Motion to Dismiss when examined in light of the elements of § 523(a)(4).

IV. ORDER

Taking the allegations of the Complaint as true and considering it in the light most favorable to Plaintiffs, as required by Rule 12(b)(6), the Court directs the following:

1. With respect to Count I, alleging a cause of action under 11 U.S.C. § 523(a)(2)(A), the Motion to Dismiss is GRANTED, and the Complaint is DISMISSED.

2. With respect to Count II, alleging a cause of action under 11 U.S.C. § 523(a)(4), the Motion to Dismiss is DENIED.

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