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PRIOR JUDGMENT INSUFFICIENT FOR PURPOSES OF COLLATERAL ESTOPPEL

In *State of New York v. Salwa Georges Khouri*, Adv. No. 07-3230 (Bankr. D. Minn. Nov. 11, 2008) (J. Kishel), the Bankruptcy Court denied the State of New York's Motion for Summary Judgment seeking determination that debt was excepted from discharge because judgment did not meet the elements of section 523(a)(2), (a)(4) or (a)(6).

Salwa Georges Khouri (the "Debtor") was a doctor in the State of New York (the "State") in the 1980s, during which time she participated in the State's Medicaid program. In 1989, an audit performed by the State determined that the Debtor failed to comply with billing and record-keeping requirements, resulting in alleged overpayments of $428,963.18. Ultimately, a New York administrative law judge ("ALJ") rendered a decision affirming the audit findings.

In October 2008, the Debtor filed a Chapter 7 case. The State commenced an adversary proceeding seeking to have the Debtor's debt to it excluded from the discharge under sections 523(a)(2), 523(a)(4) and 523(a)(6).

In its motion for summary judgment, the State argued that the Debtor was bound by the findings of fact made by the ALJ, and that the ALJ's findings met all of the elements of one or more bases for a determination of nondischargeability, thereby entitling it to summary judgment. The court noted that "it is long-established that the doctrine of collateral estoppel, or 'issue preclusion,' applies in nondischargeability proceedings in bankruptcy, to bar a party from relitigating discrete issues of fact that were settled via adjudication in pre-bankruptcy litigation to which the debtor was a party." *Id.* at 4 (quoting *In re Porter*, 539 F.3d 889, 894 (8th Cir. 2008)).

To prevail under section 523(a)(2)(A), the State had to establish that the ALJ made specific findings satisfying the following elements "(i) the debtor made a false representation of fact, (ii) that the debtor knew was false at the time the debtor made it, (iii) that the debtor made the representation with the intent and purpose of deceiving the creditor, and (iv) that the creditor justifiably relied on the representation, (v) sustaining financial injury as a proximate result of the making of the representation." *Id.* at 7 (quoting *In re Van Horne*, 823 F.2d 1285, 1287 (8th Cir. 1987)). After reviewing the ALJ's findings, the court found that such findings did not satisfy any of the five elements enumerated above.

The court also held that the findings did not satisfy all of the elements of either section 523(a)(4) or section 523(a)(6). Because the State was not able to establish that the elements of sections 523(a)(3), 523(a)(4) and 523(a)(6) had been previously litigated and determined adversely to the Debtor, it was not entitled to summary judgment.

DEPOSITION TRANSCRIPTS EXCLUDED UNDER FED. R. CIV. P. 32(a)

In *Timothy Moratzka, Trustee of Senior Cottages of America, LLC and Senior Cottages Management, LLC v. Richard Morris, et. al.*, Adv. No. 03-3132 (Bankr. D. Minn. Jan. 13, 2009) (J. Kishel), the court denied the plaintiff's motion to use depositions taken in other actions because he could not satisfy the requirements of Fed. R. Civ. P. 32(a).

The plaintiff commenced an adversary proceeding in 2003 against Richard Morris, Michael Cohen and their law firm, Morris Carlson and Hoeshler, P.A. (collectively, the "Defendants") seeking damages against them in connection with advice provided to the Debtor and its major shareholder, Murray Klane ("Klane").

In 1998, the Debtor transferred all of its assets to Millennium Properties, LLC ("Millennium"). The Defendants represented and advised the Debtor, Millennium and their respective principals in the transaction. An action was filed and judgment was entered in Hennepin County District finding that the transfers between the Debtor and Millennium were fraudulent under the Minnesota Fraudulent Transfers Act. Shortly thereafter, Klane, the Debtor, and Millennium filed for Chapter 11.

During the Hennepin County case and nondischargeability litigation in Klane's bankruptcy case, several depositions were taken. The plaintiff proposed to use six depositions taken in those cases in the pending adversary proceeding against the Defendants.

The plaintiff argued that because Richard Carlson, a member of the defendant law firm, participated as counsel to the Debtor in the depositions conducted in the Hennepin County case, the presence requirement of 32(a)(1)(A) was satisfied:

> At a hearing or trial, all or part of a deposition may be used against a party on these conditions:
> (A) the party was present or represented at the taking of the deposition or had reasonable notice of it;
> (B) it is used to the extent it would be admissible under the Federal Rules of Evidence if the deponent were present and testifying; and
> (C) the use is allowed by Rule 32(a)(2) through (8).

The court held that Defendants were not plaintiffs or defendants in the Hennepin County case and, therefore, could not have been present as participants in the depositions. Further, Carlson's appearance in that case was on behalf of the Debtor, not on behalf of the Defendants. Accordingly, Carlson was not representing the interests of the Defendants at the depositions.

The plaintiff also sought to admit the deposition pursuant to Fed. R. Civ. P. 32(a)(8), which states:

> A deposition lawfully taken and, if required, filed in any federal- or state-court action may be used in a later action involving the same subject matter between the same parties, or their representatives or successors in interest, to the same extent as if taken in the later action. A deposition previously taken may also be used as allowed by the Federal Rules of Evidence.

The court held that the plaintiff could not satisfy this requirement because there was not a "substantial identity" of issues. The plaintiff was not suing the Defendants because they performed the fraudulent transfer, which was the subject of the Hennepin County case, rather his action sounded in malpractice for failing to advise them of the consequences of the fraudulent transfer.

With respect to the depositions taken in the Klane adversary proceeding, the court held that the plaintiff did not meet the "presence" requirement of 32(a)(1)(A). In that case the Defendants were not party to the action, nor did they represent Klane in any capacity. As such, they had no opportunity for cross-examination or to otherwise direct the course of the depositions.

As for the deposition of Defendant Richard Morris, the court did find that because Morris was present as a deponent in the Klane adversary proceeding and had a full opportunity to have counsel appear on his behalf, the plaintiff may offer appropriate portions of the deposition at trial, subject to a determination of admissibility.

CLAIMS ASSERTED BY DEBTOR AGAINST MORTGAGEE NOT "RELATED TO"

In *Pamela Rae Barsness v. Wilshire Credit Corp.* (*In re Barsness*), 398 B.R. 655 (Bankr. D. Minn. Dec. 19, 2008) (J. Kishel), the Bankruptcy Court refused to extend "related to" jurisdiction to an adversary proceeding commenced by the Debtor against its mortgagee for alleging failing to comply with applicable law during the foreclosure proceedings.

Shortly after filing a Chapter 7 petition, the Debtor, acting *pro se*, filed what was construed by the clerk of court as an adversary complaint against Wilshire Credit Corporation ("Wilshire"). The Debtor alleged that Wilshire had violated applicable foreclosure law and requested that the Court enjoin Wilshire from further foreclosure proceedings because the Debtor intended to redeem the mortgage.

Several months after Wilshire submitted its answer, Wilshire moved for summary judgment. The Debtor then filed a document purporting to unilaterally dismiss the adversary proceeding. Citing Fed. R. Civ. P. 41(a), the Court refused to dismiss the proceeding because the dismissal was not sought by stipulation or formal motion.

The day before the hearing on Wilshire's summary judgment motion, the Debtor filed a motion to dismiss. At the hearing on Wilshire's motion, the Court considered the Debtor's motion and denied it in all respects, but one. The Court took under advisement the Debtor's contention of "Improper Jurisdiction."

The Court began its analysis by discussing the contours of bankruptcy court jurisdiction. The Court noted that original jurisdiction over bankruptcy cases and proceedings is granted to the district courts by 28 U.S.C. § 1134(a)-(b). The district courts, in accordance with 28 U.S.C. § 157(a), are empowered to refer all cases under the Code and all proceedings arising under the Code or arising in or related to a case under Code to the bankruptcy courts for that district. A bankruptcy court's exercise of jurisdiction is limited by the statutory distinction between "core proceedings" and "related proceedings."

"Core proceedings" are those that arise only in bankruptcy or involve a right created by federal bankruptcy law. The Court distinguished "related to" proceedings which encompass a much boarder range of proceedings in which the outcome could conceivably have an effect on the estate being administered in bankruptcy.

The Court reasoned that the Debtor's adversary proceeding did not constitute a core proceeding because (1) the claims would be decided solely with reference to Minnesota law and (2) the Code neither spoke to the foreclosure process at issue nor contained a provision under which the requested relief could be granted.

As to whether the Debtor's adversary proceeding was a "related to" proceeding, the Court noted that all of the Debtor's assets were scheduled as exempt, the exemptions were allowed and the Debtor's bankruptcy case was closed. Because there was no bankruptcy estate in existence, the outcome of the Debtor's adversary proceeding could not effect the administration of the estate in bankruptcy and, accordingly, the proceeding was not "related to."

Citing *In re Holmes*, 387 B.R. 591 (Bankr. D. Minn. 2008), the Court recognized that a proceeding challenging the mortgagee's rights in real property could qualify as a "related to" proceeding, but only if (1) the Debtor's bankruptcy case was still open (2) the outcome of the proceeding could motivate the Debtor to amend exemptions in a manner that deprived the estate of assets, and (3) the Debtor has committed to so do.

The Court noted that the Debtor's bankruptcy case was closed and that the Debtor sought not to free the property of Wilshire's interest, but instead only an extension of the time when full title would vest in the purchaser of the property. That relief, even if granted, would not affect the claims to the real estate's value.

BANKRUPTCY COURT'S STATEMENTS ADMISSIBLE IN DEBTORS' CRIMINAL PROCEEDING

In *United States v. Bauer*, Case Nos. 08-1043 and 08-1209 (8th Cir. Dec. 29, 2008) (J. Wollman), the Eighth Circuit upheld the district court's admission of statements from the bankruptcy court as evidence in the Debtors' subsequent criminal trial, and rejected Rae Bauer's violation of attorney-client privilege argument.

The Debtors were charged with twelve counts of bankruptcy fraud and money laundering. These charges stemmed from the misstated value of their home and failure to list funds held in an IRA account on their bankruptcy schedules. Shortly after filing, the Debtors filed a homeowner's insurance claim listing the value of their house at a value three and a half times what was claimed on their schedules. Once the Trustee had the bankruptcy case reopened to deal with the additional home value, he learned of the Debtors' IRA account. The bankruptcy court revoked the Debtors' previous discharge, ordered that the insurance proceeds for their house and IRA funds were assets of the estate, and ordered that the proceeds from the house and IRA be turned over to the Trustee. Instead of turning over these proceeds, the Debtors spent or buried all the cash. The government then initiated this criminal trial against the Debtors.

During the criminal case, the district court admitted the bankruptcy court's statement to the Debtors alerting them that absconding with assets of the bankruptcy estate was a violation of federal law, and doing so could lead to criminal charges. On appeal, the Debtors argued that the district court erred in admitting these statements. The Eighth Circuit, however, found there was no abuse of discretion, and upheld the district court's admission of such evidence because it was relevant to prove the Debtors failure to turn over the money was not an innocent mistake. It was also noted that the government omitted statements from the bankruptcy court that found the Debtors in contempt, and that the jury in the criminal trial was carefully instructed to keep the bankruptcy and criminal trial proceedings separate, so the evidence was not unfairly prejudicial. Because the government only used limited statements from the bankruptcy court proceeding to prove the Debtors' intent to perpetrate fraud, and not to prove of the fraud itself, the bankruptcy court's statements were properly admitted as evidence in the criminal trial.

The government also introduced the testimony of the Debtors' bankruptcy attorney who helped the Debtors prepare their bankruptcy petition and schedules to rebut the argument that the errors in the bankruptcy petition were a result of inaccurate information and bad legal advice from the attorney. Rae Bauer argued that this testimony violated her attorney-client privilege, but the Eighth Circuit rejected this argument because Rae Bauer waived her attorney-client privilege "by choosing to make her attorneys' performance a central element to her defense." The Court also questioned whether discussions with an attorney regarding information listed on publicly filed bankruptcy schedules are even protected by attorney-client privilege. *See U.S. v. Cote*, 456 F.2d 142, 145 n.3 (8th Cir. 1972).

MORTGAGE OMITTING SECTION, TOWNSHIP AND RANGE NOT AVOIDABLE

In *Ries v. Ibach* Adv. No. 06-3476 (Bankr. D. Minn. Dec. 12, 2008) (J. Kishel), the Bankruptcy Court preserved a flawed mortgage against the avoidance powers of the Trustee under 11 U.S.C. § 544.

A lender recorded a mortgage containing a legal description that omitted the section, township and range information. The lender realized the error in the legal description after the debtor filed for bankruptcy and recorded an amended mortgage post-petition. The Chapter 7 Trustee sought to avoid the mortgage under section 544, and as an avoidable preference under section 547. Trustee also sought judgment in the amount of the mortgage.

The validity of the first mortgage turned on whether the legal description as recorded would have provided the trustee, as a hypothetical bona fide purchaser, with constructive notice under state law. If a bona fide purchaser would have constructive notice based on the recorded documents and chain of title, the Trustee's avoidance action fails. The test for constructive notice is whether an error in the recorded documents is apparent. Citing Minnesota state law, the Court stated an "apparent" defect is one that "'put[s] the party [that is subject to constructive notice] on inquiry as to the existence of an outstanding interest.' " Once on inquiry, the party must further investigate to confirm whether another party indeed has an interest against the property.

The Court ruled the absence of section, township and range information from the legal description was a patent and apparent error, and that any potential bona fide purchaser seeing the mortgage in the grantor – grantee index would be on constructive notice of the potential interest and need to inquire further to determine what property was subject to the mortgage. Inquiry in this case would have led a potential purchaser to the actual warranty deed in the grantor-grantee index with the correct legal description. The potential purchaser could also inquire of the grantor of the mortgage to confirm whether the grantor intended to provide a mortgage on the parcel at issue. As a result, the trustee could not set aside the mortgage under its strong-arm powers.

Because the first mortgage was not avoidable, the creditor did not take action against the property of the estate or improve its position by recording the amendment. Since the first mortgage was valid and left no equity in the property, the Trustee did not have standing. Accordingly, the counts for judgment against the creditor for the post-petition perfection failed.

DEBTORS' EXEMPTIONS DENIED FOR BAD FAITH

In *In re James Robert Barrows and Terri Lee Barrows*, Bky. No. 09-43503 (Bankr. D. Minn. Jan. 9, 2009) (J. Kressel), the bankruptcy court sustained the trustee's objection to the Debtors' claimed exemptions because of material misstatements.

The Debtors sought the advice of a bankruptcy attorney and as such, they were asked to fill out information on a worksheet. The attorney's worksheet stated, "Official Bankruptcy Forms will be completed using the information that you give in these worksheets and you will be required to sign a declaration stating under penalty of perjury that the information is true and correct." One of the questions on the worksheet asked the Debtors to list the "approximate average daily balance" in their bank accounts. For their joint TCF checking and savings accounts they listed $300.00 and $25.00.

After filing out the worksheet and returning it to their attorney, the Debtors then applied for and received a loan from their 401(k) in the amount of $17,000. This loan was then deposited in to their TCF checking account. When the Debtors returned to their attorney's office to review their petition and schedules prior to filing, they knew of their $17,000 loan, but did not mention it to their attorney.

On the date of filing, the Debtors had a balance of $13,918.89 in their TCF account, significantly more than the $325.00 that was listed in their schedules. The Debtors also disclosed a 401(k) on Schedule B, and listed the current value to be $65,000.00. Both assets were claimed as exempt in Schedule C. The Debtors did not list the 401(k) loan in their Statement of Financial Affairs, nor did they indicate any expected changes in income despite having just received the $17,000.00 loan.

At the meeting of creditors, the Debtors testified under oath that their petition and schedules were true, correct and complete. They also provided the trustee with copies of their bank account statements that showed the balance in their account on the date of filing was over $13,918.89, however, they did not specifically disclose the 401(k) loan to the trustee at the meeting.

Upon review of the bank statement, the trustee discovered that the Debtors had $13,918.89 in their checking account and demanded turnover of all funds in excess of the $325.00 claimed exemptions. In response, the Debtors filed amended schedules valuing their bank accounts at $13,970.19, and then sought to exempt the entire amount under 11 U.S.C. § 522(d)(5).

The court stated that the issue was not whether Debtors could amend their schedules, but rather was whether the Debtors could "successfully exempt their TCF Bank checking account in the face of an objection, when they knew they had approximately $13,900.00 in the account but had failed to disclose it on their schedules or statement of financial affairs or at their meeting of creditors?"

The court cited *Kaelin v. Bassett (In Re Kaelin)*, for the proposition that an exemption can be disallowed where the debtors have acted in bad faith or where the creditors have been prejudiced. 308 F.3d 885, 889 (8th Cir. 2002). The court held the Debtors acted in bad faith based on the totality of the circumstances because: (1) "the debtors knew they had approximately $13,900.00 in their TCF Bank accounts and they knew their schedules indicated the balances to be $325.00;" and (2) "they omitted any reference to the transfer on their statement of financial affairs and testified at their meeting of creditors that their schedules were true, correct, and complete." The Debtors had a duty to provide accurate and complete information in preparing their schedules, and at the very least, acted with reckless indifference when they failed to correct the mistake.

The court also commented on the conduct of the Debtors' attorney. His mistakes included that his worksheet asked the wrong question, which is why it garnered the wrong information; that he failed to ask them questions during the process of preparing the petition and schedules which may have uncovered this information; and that he allowed for weeks to pass between the time he received their worksheet, the day they signed their petition and schedules, and the day he filed them. Ultimately though, the "responsibility to be accurate fell on the debtors" and that the inaccuracies on the petition and schedules, which were signed under oath, should have been obvious to the Debtors.

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