**UNITED STATES BANKRUPTCY COURT**
**DISTRICT OF DELAWARE**

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| IN RE:<br><br>JOSEPH S. LLOYD,<br><br>Debtor. | Chapter 7<br><br>Case No. 99-4413 (MFW) |
| DENNIS L. WHITESEL,<br>BETTY LOU GRIFFITH and<br>WILLIAM GRIFFITH,<br><br>Plaintiffs,<br><br>v.<br><br>JOSEPH S. LLOYD,<br><br>Defendant. | Adversary No. A-00-415 (MFW) |

**MEMORANDUM OPINION**[1]

Before this Court is the complaint filed by Dennis L. Whitesel ("Whitesel") and Betty Lou and William Griffith ("the Griffiths") against Joseph S. Lloyd ("the Debtor") seeking a determination that their claims are not dischargeable pursuant to section 523(a)(2) as having been incurred by fraud. After a hearing held on July 31, 2000, and consideration of the evidence presented, we enter judgment for the Debtor for the reasons set forth below.

[1] This Opinion Constitutes the findings of fact and conclusions of law of the Court pursuant to Federal Rule of Bankruptcy Procedure 7052.

## I. BACKGROUND FACTS

In late 1996, the Debtor met with Whitesel, who was an old high school friend. Whitesel was interested in investing in a franchise of a chain of restaurants and asked the Debtor, who had over 25 years of restaurant experience, for his advice. During these discussions, the Debtor mentioned his interest in opening his own restaurant. When Whitesel asked the Debtor why he had left his last employment at the Glass Kitchen restaurant, the Debtor claimed he had left over a dispute regarding an alleged promise of future ownership in the restaurant. The Debtor did not disclose the true reason: that he had been fired for embezzlement of $500 to cover gambling debts. Subsequently, Whitesel and the Debtor discussed the possibility of joining their resources for the purpose of purchasing and operating a restaurant in Middletown, Delaware.

The Debtor had apparently also advised his in-laws (the Griffiths) of his interest in running his own restaurant. They also agreed to invest in the venture. Prior to that time, the Debtor had not advised the Griffiths of the reason he had left the Glass Kitchen.

On April 17, 1997, the Plaintiffs and the Debtor formed the Lighthouse Family Restaurant, LLC ("the Lighthouse"), a Delaware limited liability company. Whitesel and Lloyd each held a one-third membership interest and the Griffiths together held a one-third membership interest. Whitesel invested $30,000 in cash and lent the Lighthouse an additional $20,000. The Griffiths did the same. The Debtor invested $22,500 in cash at the initial stage. On June 6, 1997, the Lighthouse purchased a restaurant from Food Management, Inc., for $175,000. (Exhibit P-2.) At the same time, the Lighthouse borrowed $200,000 from Wilmington Trust Company. (Exhibits P-3, P-4, P-5 & P-6.) To secure these loans, the Debtor and his wife, the Griffiths, and Whitesel all executed personal guarantees and mortgages on real estate owned by them. (Exhibits P-7, P-8, P-9 & P-10.) In exchange for investing less money in the Lighthouse, the Debtor agreed to use his prior experience to manage the daily operations for a fixed salary of $600 per week.

During the first year of operations, the Lighthouse (though losing money) performed ahead of projections. The second year, however, had lower traffic (and revenues) than expected.[2] Because the Lighthouse could not afford his salary, the Debtor worked without being paid. The Debtor ultimately had to find another job (at a car dealership), though he continued to work at the Lighthouse mornings, evenings and weekends without pay. In the Fall of 1998, the Debtor advised the Plaintiffs of the Lighthouse's need for cash to continue to operate; the Plaintiffs refused to invest any further in the restaurant. Subsequently,

[2] During this same time, the Debtor was experiencing marital problems resulting in his wife ultimately leaving him.

the Debtor invested an additional $21,000 between November, 1998, and Spring 1999 to keep the Lighthouse open. (Exhibit D-1.) The Debtor had retained a broker in early 1998 to sell the restaurant. However, these efforts were unsuccessful and the Lighthouse was forced to close its doors on April 13, 1999.[3]

As a result, Wilmington Trust Company called on the Plaintiffs and the Debtor to pay on their guarantees. The Plaintiffs collectively paid the Wilmington Trust Company the loan balance totaling $175,283.83 (the Griffiths paying half and Whitesel paying half). (Exhibit P-11.) They obtained an assignment of the mortgage held by Wilmington on the Debtor's home and are foreclosing on it. (Id.)

In this action, the Plaintiffs seek an order determining that the damages sustained by their investment in the Lighthouse (presumably the initial investments totaling $100,000 plus the Wilmington Trust debt of approximately $175,000) are not dischargeable pursuant to section 523(a)(2) as a debt obtained by false representations or fraud. Specifically, the Plaintiffs assert that they would not have invested with the Debtor had they known of his embezzlement from the Glass Kitchen.

## II. JURISDICTION

[3] There is no suggestion in the pleadings or evidence in the record that the Lighthouse failed because of any embezzlement of funds by the Debtor.

This Court has jurisdiction over this adversary proceeding, which is a core proceeding pursuant to 28 U.S.C. § 1334 and §157(b)(2)(I).

## III. DISCUSSION

### A. Exceptions to Discharge of Debt

The overriding purpose of the Bankruptcy Code is to relieve debtors from the weight of oppressive indebtedness and provide them with a fresh start. Exceptions to discharge are strictly construed against creditors and liberally construed in favor of debtors. See In re Cohn, 54 F.3d 1108, 1113 (3d Cir. 1995). However, the Supreme Court has instructed that only "honest and unfortunate" debtors should be afforded a "fresh start" in bankruptcy. See Grogan v. Garner, 498 U.S. 279, 287 (1991). Thus, section 523(a)(2)(A) represents a policy determination that the goal of providing debtors with a fresh start must yield to the protection of creditors against fraud. Fundamentally, the section seeks to prevent debtors from incurring debt with the intention of not paying by obtaining a discharge in bankruptcy. See In re Feld, 203 B.R. 360, 365 (Bankr. E.D. Pa. 1996).

Section 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.

11 U.S.C. § 523(a)(2)(A) (1988).

The burden of proving that a debt is nondischargeable under section 523(a) is on the creditor, who must establish entitlement to an exception by a preponderance of the evidence. Grogan, 498 U.S. at 287-88.

Under section 523(a)(2)(A), the party objecting to discharge must prove that:

1. The debtor made the misrepresentations or perpetrated fraud;
2. the debtor knew at the time that the representations were false;
3. the debtor made the misrepresentations with the intention and purpose of deceiving the creditor;
4. the creditor reasonably relied on such misrepresentations; and
5. the creditor sustained loss and damages as a proximate result of the misrepresentations having been made.

See, e.g., In re Brady, 101 F.3d 1165, 1172 (6th Cir. 1993); In re Henderson, 134 B.R. 147, 162 (Bankr. E.D. Pa. 1991).

Recently, the Supreme Court has held that the proper measure for reliance is not the objective or "reasonable" standard, but a less demanding "justifiable" reliance standard. Field v. Mans, 116 S.Ct. 437, 445-465 (1995).

The Debtor has admitted that he lied to Whitesel about the reasons for his dismissal from the Glass Kitchen. The Debtor did not make a similar statement to the Griffiths but admits that he did not tell them the real reason he left the Glass Kitchen before they invested in the Lighthouse.[4] Since the misrepresentation was made at the time the Debtor and the Plaintiffs were discussing the investment in the Lighthouse it is easy to conclude that the Debtor intended to deceive them. However, we conclude that the necessary element of reasonable reliance is missing here.

With respect to the Griffiths, we conclude that they did not rely on the Debtor's misrepresentation in making their investment decision. Mrs. Griffith testified tepidly that she "probably would not have" invested in the Lighthouse if she had known the truth about the Debtor's termination from the Glass Kitchen. Since the Debtor was the Griffiths' son-in-law at the time of the

[4] See, e.g., In re Barrack, 217 B.R. 598 (B.A.P. 9th Cir. 1998)(nondisclosure of a material fact in face of a duty to disclose satisfies reliance and causation elements for fraud under section 523(a)(2)(A)); In re Howarter, 114 B.R. 682, 684 n.2 (B.A.P. 9th Cir. 1990)(debtor's silence or concealment of a material fact can create a false impression which constitutes a misrepresentation actionable under section 523(a)(2)(A)).

investment, we believe it unlikely that the Griffiths would have refused to invest in his and their daughter's dream of owning a family restaurant if they had known of the $500 embezzlement.[5]

Similarly, although Whitesel's testimony on this point was unequivocal -- he said he definitely would not have invested with the Debtor if he had known the truth -– we did not find this testimony credible.  Whitesel has been friendly with the Debtor since high school and specifically sought the Debtor's advice about investing in restaurants.  Whitesel had already determined that investing in a restaurant interested him.  Further, he (and his accountant) did extensive due diligence before he actually invested in the Lighthouse.  He relied on the results of that investigation and projections of the expected return on his investment in making his decision.  His investment with the Debtor was driven in large part by the Debtor's extensive experience (over 25 years managing a similar family style restaurant).  We believe that even if Whitesel had known of the $500 embezzlement, he still would have invested in the Lighthouse with the Debtor.

Consequently, we conclude that an essential element of section 523(a)(2)(A) has not been proven.  The debt is, therefore, dischargeable.

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[5] While we do not treat any embezzlement lightly, the amount is relevant to our evaluation of the issue of reliance.

## IV. CONCLUSION

For the foregoing reasons, the Plaintiffs' claims against the Debtor are determined to be dischargeable. An appropriate Order is attached.

BY THE COURT:

Dated: August 25, 2000

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Mary F. Walrath
United States Bankruptcy Judge

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**O R D E R**

AND NOW, this **25TH** day of **AUGUST, 2000**, upon consideration of the Complaint filed by Dennis L. Whitesel, Betty Lou Griffith, and William Griffith against Joseph S. Lloyd, after a hearing held on July 31, 2000, and the evidence presented therein, and for the reasons set forth in the accompanying Opinion, it is hereby

**ORDERED** that judgment is hereby entered in favor of the Debtor and the debts owed to the Plaintiffs are **DISCHARGEABLE** pursuant to 11 U.S.C. § 523(a)(2)(A).

BY THE COURT:

Mary F. Walrath
United States Bankruptcy Judge

cc: See attached

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