United States Bankruptcy Court
District of New Mexico

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UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEW MEXICO

In re:
MINERVA J. BALIZAN-DIAZ,
Debtor. No. 7-04-12868 SL

DALE SCHUELLER, et al.,
Plaintiffs,
v. No. 04-1159 S

MINERVA J. BALIZAN-DIAZ,
Defendant.

MEMORANDUM OPINION ON DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

This matter is before the Court on Defendant's Motion for Summary Judgment ("Motion")(doc. 13) and Plaintiffs' reply thereto (doc. 16). Plaintiffs appear through their attorney Holt & Baggington, P.C. (Matthew P. Holt). Defendant appears through her attorney Steve H. Mazer. This is a core proceeding. 28 U.S.C. § 157(b)(2)(I).

PROCEDURAL ISSUES

Defendant's Motion seeks summary judgment under Bankruptcy Rule 7056, which adopts Fed.R.Civ.P. 56. Federal Rule 56 states, in part:

> ...
> (b) For Defending Party. A party against whom a claim, counterclaim, or cross-claim is asserted or a declaratory judgment is sought may, at any time, move with or without supporting affidavits for a summary judgment in the party's favor as to all or any part thereof.
> (c) Motion and Proceedings Thereon. ... 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.
> (e) Form of Affidavits; Further Testimony; Defense Required. Supporting and opposing affidavits shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and shall show affirmatively that the affiant is competent to testify to the matters stated therein. Sworn or certified copies of all papers or parts thereof referred to in an affidavit shall be attached thereto or served therewith. The court may permit affidavits to be supplemented or opposed by depositions, answers to interrogatories, or further affidavits.

"A summary judgment motion must be supported in such a way as to allow a bankruptcy court to credibly determine if '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.'" Harris v. Beneficial Oklahoma, Inc. (In re Harris), 209 B.R. 990, 995 (10th Cir. B.A.P. 1997)(quoting Fed.R.Civ.P. 56(c).)

> Although affidavits are not strictly required by Rule 56 or case law, in practice they are usually necessary to obtain summary judgment.... [I]t makes sense to distinguish between affidavits that primarily give testimony and affidavits that are used primarily to introduce documents so that the court may consider the documents in determining whether material factual matter is genuinely in dispute. A party seeking to rely on material other than affidavits to obtain summary judgment may nonetheless need to use an affidavit to place these materials before the court and into the official record. ...
> In order for documents not yet part of the court record to be considered by a court in support of or in opposition to a summary judgment motion they must

> meet a two-prong test: (1) the document must be attached to and authenticated by an affidavit which conforms to Rule 56(e); and (2) the affiant must be a competent witness through whom the document can be received into evidence. ...
> Documentary evidence for which a proper foundation has not been laid cannot support a summary judgment motion, even if the documents in question are highly probative of a central and essential issue in the case.

Id. at 995-96 (quoting 11 James Wm. Moore et al., Moore's Federal Practice §§ 56.10[4][c][i] & 56.14[2][c](3d ed. 1997)(footnotes omitted.)). See also United States v. Dibble, 429 F.2d 598, 602 (9th Cir. 1970)(Unauthenticated summary judgment exhibits are inadmissible hearsay.); White v. Wells Fargo Guard Services, 908 F.Supp. 1570, 1579 (M.D. Ala. 1995)(Court may not consider documents not sworn or certified as required by Fed.R.Civ.P. 56(e).)

Defendant's Motion contains no affidavits, there are no previous affidavits on file in this case, and the exhibits attached to the Motion are inadmissible hearsay. Therefore, the Court cannot consider the exhibits as part of the Motion[1].

[1] Plaintiffs did not object to the Motion's exhibits or move to strike them. However, under Rule 56(c), the Court shall render a judgment if there is no genuine issue of material fact and "the moving party is entitled to a judgment as a matter of law." This Court believes that a party is not entitled to judgment as a matter of law based on inadmissible evidence. Therefore, Plaintiffs failure to object is not determinative.

A motion based on one or more pleadings alone is the equivalent of a motion to dismiss under Fed.R.Civ.P. 12(b)(6) or 12(c)[2]. 10A Wright, Miller, and Kane, Fed. Prac. & Proc. Civ. 3d § 2722 (1998 & Supp. 2004); Aldera Corp. v. MJ Research Inc., 297 F.Supp.2d 459, 460 (D. Ct. 2004). Therefore, the Court will treat the Motion as one to dismiss under Rule 12(b)(6).

When deciding a motion to dismiss under Rule 12(b)(6), the Court must accept all well-pleaded allegations as true, Albright v. Oliver, 510 U.S. 266, 268 (1994), and draw all reasonable inferences in favor of the pleader, Scheuer v. Rhodes, 416 U.S. 232, 236 (1974). A complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his or her claim which would entitle plaintiff to relief. Conley v. Gibson, 355 U.S. 41, 45-46 (1957). "The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims. Indeed it may appear on the face of the pleadings that a recovery is very remote and unlikely but that is not the test." Scheuer, 416 U.S. at 236.

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[2] Rule 12(c) provides for judgment on the pleadings "after the pleadings are closed." The pleadings have not closed in this case.

THE COMPLAINT

Plaintiffs allege that $210,940.08 remains due on a state court Default Judgment, and that they discovered that this debt is based in part upon money being obtained by Defendant under false pretenses, false representations and actual fraud, while Defendant was acting in a fiduciary capacity for Plaintiffs[3]. Plaintiffs allege that Plaintiffs and Defendants entered into an agreement before September 14, 1998 to operate a business for profit as a New Mexico limited liability company ("LLC"). The LLC was never formed, but the parties started the business anyway. Defendant was to be in full charge of the business. Plaintiffs did not participate in managing the business. On four different specified dates Plaintiffs loaned a total of $45,000 to Defendant, which was deposited into the business account. These amounts, as well as other amounts given by check in an amount to be determined, were to be used by Defendant in capitalizing the business. Based on information Plaintiffs obtained in the state court

[3] Defendant argues that because causes of action under 523(a)(2) and 523(a)(4) are not broken out in the complaint specifically, it should be dismissed. While the Court agrees that the complaint, filed by previous counsel, is difficult to follow, under Fed.R.Civ.P. 8(e) and (f) no technical forms of pleading are required and pleadings should be construed to do substantial justice. Therefore, it will not be dismissed on those grounds.

case, they allege “upon information and belief” that Defendant diverted the funds to her own use by transferring the money to her sole proprietorship and then to herself and her husband. Plaintiffs also allege “upon information and belief” that Defendant diverted revenue from the business by using the business’ funds to purchase inventory for her sole proprietorship and by registering business sales as sole proprietorship sales.

Plaintiffs seek a determination that the $45,000 loaned was an extension of credit obtained under false pretenses, false representations, or fraud, and constitutes defalcation as a fiduciary or embezzlement. Plaintiffs also seek a determination that the diversion of sales revenues is a defalcation by a fiduciary or embezzlement. Plaintiffs cite both 11 U.S.C. § 523(a)(2) and 11 U.S.C. § 523(a)(4)[4].

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[4] 11 U.S.C. § 523 provides, in part:
(a) A discharge under section 727... 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;
...
(4) for fraud or defalcation while acting in a
(continued...)

DEFENDANT'S MOTION

Defendant's Motion has two main arguments. First, it argues that under the principles of res judicata and collateral estoppel, because the original and amended state court complaints that resulted in the Default judgment made no allegations to support a Section 523 claim, the Plaintiff is now precluded by the Default Judgment from raising those issues in this adversary. Second, it argues 1) that the complaint fails to state a claim because fraud was not pled specifically and 2) that the complaint does not state a cause of action for breach of fiduciary duty or embezzlement. These will be addressed in turn.

A. Res Judicata and Collateral Estoppel

Plaintiff's Memorandum in Opposition to Defendants Motion for Summary Judgment (doc. 16) correctly states the current bankruptcy law on res judicata and collateral estoppel. Under Archer v. Warner, 538 U.S. 314 (2003)[5] and Brown v. Felsen, 442 U.S. 127 (1979), it does not matter if a state court

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[4](...continued)
fiduciary capacity, embezzlement, or larceny...

[5] The Archer court specifically rejected the "novation theory" applied by the Fourth Circuit. 538 U.S. at 320. Under this theory, a settlement converts a potentially nondischargeable tort claim into a dischargeable contract claim. Archer v. Warner (In re Warner), 283 F.3d 230, 236 (4th Cir. 2002).

lawsuit fails to allege the elements of a dischargeability complaint, and, after settlement or judgment, if a bankruptcy is filed, the bankruptcy court is free to look behind the settlement or judgment to see if the underlying debt was one that would be nondischargeable. Defendant's cases to the contrary were either reversed or are overruled.[6] Therefore, even if Defendant's exhibits, which have not been considered, showed that the state court complaint did not contain Section 523 allegations, Defendant's motion should be denied.

B. Failure to State a Claim

1. The Rule 9(b) motion.

Federal Rule of Civil Procedure 9(b) states "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." Defendant, citing American Express

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[6] Specifically, Archer v. Warner (In re Warner), 283 F.3d 230 (4th Cir. 2002) was reversed by the Supreme Court at 538 U.S. 314 (2003). Monsanto Co. v. Trantham (In re Trantham), 286 B.R. 650 (Bankr. W.D. Tenn. 2002) was reversed by the Sixth Circuit Bankruptcy Appellate Panel at 304 B.R. 298 (6th Cir. BAP 2004). Oltman v. West (In re West), 157 B.R. 626 (Bankr. N.D. Ill. 1993) was affirmed by the Seventh Circuit at 22 F.3d 775, 777 (7th Cir. 1994) by applying the novation theory, so is no longer good law. Cheripka v. Republic Ins. Co. (In re Cheripka), 1991 WL 276289 (3rd Cir. 1991) was vacated by the Third Circuit on January 22, 1992 in an unpublished opinion, and therefore is no longer good law.

Travel Related Services Co., Inc. v. Henein, 257 B.R. 702, 706 (E.D. N.Y. 2001), claims that this rule requires a complaint to set forth the alleged fraudulent statements, identity of the speaker, time and place of the statements, and nature of the misrepresentation. Defendant, citing Madison-Onondaga Corp. v. Kanaley (In re Kanaley), 241 B.R. 795, 803 (Bankr. S.D. N.Y. 1999), also claims that Rule 9 prohibits pleading fraud or misrepresentation based "on information and belief." Because the complaint fails to specify some of the requirements of Henein and makes two statements based on information and belief, Defendant asks the Court to dismiss[7].

The Tenth Circuit strictly adheres to a "relaxed pleading standard" for Rule 9(b). Scheidt v. Klein, 956 F.2d 963, 967 (10th Cir. 1992). Rule 9(b) should be read in conjunction with Rule 8 which calls for pleadings to be simple, concise, and direct and to be construed as to do substantial justice. Schwartz v. Celestial Seasonings, Inc., 124 F.3d 1246, 1252 (10th Cir. 1997). Rule 9(b) requires only the identification of the "circumstances constituting fraud." Id.

> [There is a] distinction between the pleading of the "circumstances of the fraud," as required by the

[7] A dismissal under Rule 9(b) is treated as a motion to dismiss for failure to state a claim under Rule 12(b)(6). Seattle-First National Bank v. Carlstedt, 800 F.2d 1008, 1011 (10th Cir. 1986).

> rule, and the pleading of "facts." Although circumstances may consist of facts, the obligation to plead circumstances should not be treated as requiring allegations of facts in the pleading, and neither Rule 8 nor Rule 9(b) requires fact pleading, although, realistically, that often will be the easiest way to present the necessary material regarding the alleged fraud.

5A Wright, Miller, and Kane, Fed. Prac. & Proc. Civ. 3d § 1298 (1998 & Supp. 2004)(footnotes omitted.) Furthermore, allegations of fraud may be based on information and belief when the facts in question are particularly within the opposing party's knowledge and the complaint sets forth the factual basis for that belief. Scheidt, 956 F.2d at 967; Kanaley, 241 B.R. at 803. "Simply stated, a complaint must set forth the time, place and contents of the false representation, the identity of the party making the false statements and the consequences thereof." Schwartz, 124 F.3d at 1252. (Citations and quotation marks omitted.) "Mere conclusory allegations of fraud" are insufficient. Id.[8]

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[8] The forms approved by Fed.R.Civ.P. 84 illustrate how minimal can be the allegations in a complaint and still be sufficient. The substantive allegations of several of the forms comprise no more than one or two sentences. Judge Easterbrook's standard is similarly minimal (but more memorable):

> Fed.R.Civ.P. 9(b) requires the plaintiff to state "with particularity" any "circumstances constituting fraud". Although states of mind may be pleaded generally, the "circumstances" must be pleaded in detail. This means the who, what, when, where and

(continued...)

The Court finds that the complaint in this case meets the requirements of Rule 9(b). It identifies a single defendant and there is no question regarding the identity of the speaker. It states that the parties entered into an agreement to operate together a business for profit. It specifically lists four transfers of funds to defendant, the dates, and the identity of the accounts into which the funds were deposited. It states that the funds "were to be used by the defendant in capitalizing [the business]", but that she diverted the funds to her own use. These allegations, together, put Defendant on notice of the nature of the claims and allow her to defend against them. They sufficiently describe the "circumstances of fraud."

The complaint has two allegations "upon information and belief." The first, ¶ 4(g), states that while the funds were to be used by Defendant to capitalize the business, "Defendant on information and belief obtained during the course of litigation in New Mexico Third Judicial Court instead diverted the funds to her own use." The second, ¶ 4(h) states that upon information and belief, defendant diverted revenues from

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[8](...continued)
how: the first paragraph of any newspaper story. Dileo v. Ernst & Young, 901 F.2d 624, 628 (7th Cir. 1990), cert. denied, 498 U.S. 941.

the business and registered sales from the business as sales attributable to her own business. These allegations are not of fraudulent statements by the Defendant capable of being identified as to time, place, or location. Rather, these are actions which, if proven, can possibly establish the fraud of earlier representations. Therefore, they can be construed as allegations of intent or purpose of Defendant's actions, and under Rule 9(b) can be averred generally. Furthermore, the acts alleged in these two paragraphs are peculiarly within Defendant's knowledge, and Plaintiffs should be given the opportunity for discovery. The complaint will not be dismissed under Rule 9(b).

2. Breach of fiduciary duty; Embezzlement.

a. Fiduciary Duty.

In Employers Workers' Compensation Assoc. v. Kelley (In re Kelley), 215 B.R. 468, 471-72 (10th Cir. BAP 1997), the Tenth Circuit Bankruptcy Appellate Panel discussed fiduciary duty:

> Section 523(a)(4) of the Bankruptcy Code excepts from discharge any debt "for fraud or defalcation while acting in a fiduciary capacity." The Tenth Circuit recently explained the meaning of "fiduciary capacity" in this provision.
>
> > The existence of a fiduciary relationship under § 523(a)(4) is determined under federal law. However, state law is relevant to this inquiry. Under this circuit's federal bankruptcy case law, to find that a fiduciary relationship

> existed under § 523(a)(4), the court must find that the money or property on which the debt at issue was based was entrusted to the debtor. Thus, an express or technical trust must be present for a fiduciary relationship to exist under § 523(a)(4). Neither a general fiduciary duty of confidence, trust, loyalty, and good faith, nor an inequality between the parties' knowledge or bargaining power, is sufficient to establish a fiduciary relationship for purposes of dischargeability. "Further, the fiduciary relationship must be shown to exist prior to the creation of the debt in controversy." [Allen v. Romero (In re Romero)], 535 F.2d [618,] 621 [(10th Cir. 1976)].
>
> Fowler Bros. v. Young (In re Young), 91 F.3d 1367, 1371-72 (10th Cir. 1996)(additional citations omitted). We are, of course, obliged to apply this narrow view of the fiduciaries who are covered by § 523(a)(4).

The Kelley court also noted that state statutes often, but not always, impose trusts on persons held to be fiduciaries as a matter of law based on their relationships. Id. at 473. See also Van de Water v. Van de Water (In re Van de Water), 180 B.R. 283, 289 (Bankr. D. N.M. 1995)(“The trust requirement is not limited to trusts arising out of a formal agreement, but includes relationships in which trust-type obligations are imposed pursuant to statute or common law.”)(Citation omitted.) A state statute must meet three requirements to trigger section 523(a)(4)’s fiduciary status: (1) the trust res must be defined by the statute, (2) the statute must spell out the fiduciary duty, and (3) the statute must impose a

trust on funds prior to the act creating the debt. Kelley, 215 B.R. at 473.

The Court will examine the complaint in light of these factors. First, the Court notes that the existence of a fiduciary duty is a question of law, not a fact that can be pled. Van de Water, 180 B.R. at 289 (Fiduciary capacity is a question of federal law; the general definition of fiduciary is too broad in the dischargeability context.); Fowler Brothers, 91 F.3d at 1371 ("The existence of a fiduciary relationship under § 523(a)(4) is determined under federal law.") Therefore, the Court will disregard the Complaint's conclusory allegations that Defendant was acting in a fiduciary relationship and look to the well-pled facts to see if the complaint alleges facts that could indicate such a relationship.

The complaint does not allege any facts to support the existence of an express trust. Therefore, Plaintiffs must rely on a trust imposed by state statute or common law. The only facts alleged that could support this are: (1) Plaintiff Dale Schueller and Defendant entered into an agreement to operate a business for profit to be qualified as a LLC (¶4(a)), (2) Defendant failed to execute the paperwork to cause the LLC to come into existence, but they proceeded with

their business relationship, Plaintiffs took no part in the business, and Defendant was in full charge of the business (¶4(b)), (3) Funds were advanced to Defendant to capitalize the business but she diverted them to her own use (¶4(g)), (4) Defendant diverted revenues from the business and sales from the business to her own business (¶4(h)), and (5) Defendant rendered the business a hollowed-out hulk (¶4(i)).

Taking the allegations of the complaint as true, there was an intent to do business as an LLC that never organized. Under New Mexico law, this creates a partnership. § 54-1A-202 NMSA 1978 ("[T]he association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership.") Under New Mexico law partners have statutory and common law fiduciary duties to each other. Fate v. Owens, 130 N.M. 503, 509 (Ct. App.), cert. denied, 130 N.M. 484, 27 P.3d 476 (2001). However,

> Courts of the Tenth Circuit have uniformly held that the [Uniform Partnership Act] does not create the kind of fiduciary relationship required by § 523(a)(4). [Medved v. Novak (In re] Novak [)], 97 B.R. [47] at 59 [(Bankr. D. Kan. 1987)] (UPA only creates a trust after the partners derive profits without the consent of the partnership, and the trust created is therefore that sort of trust ex maleficio which is not included within the purview of § 523(a)(4)); Beebe v. Schwenn (In re Schwenn), 126 B.R. 351 (D. Colo. 1991)(UPA does not create fiduciary relationship); Susi v. Mailath (In re

Mailath), 108 B.R. 290 (Bankr. N.D. Okla. 1989) (Oklahoma statutory law governing general partners does not create the requisite trust relationship); In re Weiner, 95 B.R. 204 (Bankr. D. Kan. 1989)(UPA does not create fiduciary relationship); see also Ragsdale v. Haller, 780 F.2d 794, 796 (9th Cir. 1986).

Holaday v. Seay (In re Seay), 215 B.R. 780, 786 n.4 (10th Cir. BAP 1997). The provision of New Mexico's Uniform Partnership Act ("UPA") which establishes standards of conduct is § 54-1A-404 NMSA 1978, which provides in part:

> (a) The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in Subsections (b) and (c).
>
> (b) A partner's duty of loyalty to the partnership and the other partners is limited to the following:
>
> (1) to account to the partnership and hold as trustee for it any property, profit or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity;
>
> (2) to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership; and
>
> (3) to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.
>
> (c) A partner's duty of care to the partnership and the other partners in the conduct and winding up of the partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct or a knowing violation of law.

Section 54-1A-404(a) creates general fiduciary duties between partners as set forth in subsections (b) and (c). Section 54-1A-404(b)(1) creates a trust. The rest of subsections (b) and (c) require the partner to "refrain" from certain activities. These latter subsections do not create a trust. Compare Fowler Brothers, 91 F.3d at 1371 ("Under this circuit's federal bankruptcy case law, to find that a fiduciary relationship existed under § 523(a)(4), the court must find that the money or property on which the debt at issue was based was entrusted to the debtor." (Emphasis added)).

The Section 404(b)(1) trust does not meet all three standards set forth in Kelley, 215 B.R. at 473, so does not implicate Section 523(a)(4). Section 404(b)(1) does identify the trust res, i.e., the property, profit or benefit derived by a partner from the use of partnership property. However, Section 404(b)(1) fails to spell out any fiduciary duties[9]. Compare Kelley, 215 B.R. at 473 (Oklahoma statute that made insurance brokers responsible "in a fiduciary capacity" for

[9] Furthermore, any statutory duty in this subsection is to the partnership, not the partners. ("to account to the partnership and hold as trustee for it ..." § 54-1A-404(b)(1) NMSA 1978)(emphasis added). A Section 523(a)(4) plaintiff must prove (1) a fiduciary relationship between the plaintiff and the debtor, and (2) fraud or defalcation committed by the debtor "in the course of that fiduciary relationship." Fowler Brothers, 91 F.3d at 1371.

all funds received and stated that the broker "shall not mingle any such funds" does not sufficiently define fiduciary duties to bring it within Section 523(a)(4).) The statute also does not impose a trust on funds prior to the act creating the debt; rather, the trust results from the partner's improper use of the property which is the very act creating the debt. Compare Romero, 535 F.2d at 621 ("Further, the fiduciary relationship must be shown to exist prior to the creation of the debt in controversy.") and 535 F.2d at 622 ("[T]he obligations and duties imposed under § 67-35-26, supra, were binding upon Romero prior to any dealings he had with Allen.") Therefore, the simple fact that the parties were in a partnership[10] does not establish a fiduciary duty for

[10] Plaintiffs' complaint in this case alleges that the LLC was never formed. Because the Court is treating this matter as a motion to dismiss, those allegations are assumed true. Defendant's Summary Judgment Motion's inadmissible exhibits attempt to show that the LLC was, in fact, organized. Defendant's brief claims the LLC was organized. Plaintiffs' Memorandum in Opposition at page 9 appears to concede the formation of the LLC: "Schueller was a member of WildShooz Too!, and has been damaged as a result of a breach to the entity. ... He is alleging that [Debtor], who owed a fiduciary duty to the company, purposely and willfully misdirected money that was intended to go to the limited liability company into her own business pursuits, causing injury to the members." Defendant's exhibits also included an unsigned Operating Agreement for the LLC, but the brief admitted that it was unknown whether it was ever signed.

Even if the LLC were organized, the Court's analysis is the same (absent an operating agreement to the contrary). The

(continued...)

[10](...continued)
parties argue whether § 53-19-13 limits Defendant's duties. This section, however, deals with the liability of members and managers of an LLC to third parties for debts and liabilities of the LLC. Plaintiffs are not claiming the LLC owes them anything in this adversary proceeding. This section does not apply. Furthermore, this section states: "Nothing in this section shall be construed to immunize any person [note: not just member or manager] from liability for the consequences of his own acts or omissions for which he otherwise may be liable."

Section 53-19-16 is more relevant and provides, in part:

...

B. a member who is vested with particular management responsibilities by the articles of organization or an operating agreement or a manager shall not be liable, responsible or accountable in damages or otherwise to the limited liability company or to the other members solely by reason of his act or omission on behalf of the limited liability company in his capacity as a member having particular management responsibilities or as a manager, unless such act or omission constitutes gross negligence or willful misconduct;

...

D. every member who is vested with particular management responsibilities by the articles of organization or an operating agreement and every manager shall account to the limited liability company and hold as trustee for it any profit or benefit he derives from:

...

(2) any use by such member or manager of the company's property, including confidential or proprietary information of the limited liability company or other matters entrusted to him as a result of his status as a member or manager unless: ...

This statute is very similar to § 54-1A-404(b)(1) dealing with a partner's duty to hold as trustee any property, profit or benefit derived from a use of partnership property. While it does identify a trust res, it fails to prescribe any fiduciary duties and the trust does not arise until there is an improper

(continued...)

the purposes of the Bankruptcy Code on Defendant's part. The Court therefore concludes that Plaintiffs' section 523(a)(4) claim for defalcation while acting in a fiduciary capacity should be dismissed for failure to state a claim.

Defendant also argues that any fiduciary responsibility that existed would only be to the business, not to Plaintiffs. Defendant's Memorandum in Support of Motion for Summary Judgment, doc. 13, exhibit A, p. 8. This argument is based on language in a disregarded Exhibit to the Motion and New Mexico statutes regarding LLC's. While the Court has not considered the exhibit and in this motion to dismiss the Court deems that no LLC was formed, this argument does raise prudential concerns that the Court must address[11]. Bankruptcy Rule 7017

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[10](...continued)
use. See Kelley, 215 B.R. at 473. Therefore, whether the LLC was organized or not, the result would be the same. There is no trust for Plaintiffs.

[11] In addition to satisfying the prerequisites for constitutional standing, a plaintiff must also meet, generally speaking, the requirements of prudential standing, a judicially-created set of principles that, like constitutional standing, places "limits on the class of persons who may invoke the courts' decisional and remedial powers." Warth [v. Selden], 422 U.S. [490] at 499, 95 S.Ct. 2197 [(1975)]; see also Allen [v. Wright], 468 U.S. [737] at 751, 104 S.Ct. 3315 [(1984)] (describing

(continued...)

provides that Fed.R.Civ.P. 17 applies in adversary proceedings. Rule 17(a) states, in part:

> Real Party in Interest. Every action shall be prosecuted in the name of the real party in interest. ... No action shall be dismissed on the ground that it is not prosecuted in the name of the real party in interest until a reasonable time has been allowed after objection for ratification of commencement of the action by, or joinder or substitution of, the real party in interest; and such ratification, joinder, or substitution shall have the same effect as if the action had been commenced in the name of the real party in interest.

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[11](...continued)
> prudential standing as "judicially self-imposed limits on the exercise of federal jurisdiction"). Under a prudential standing inquiry, a party that has satisfied the requirements of constitutional standing may nonetheless be barred from invoking a federal court's jurisdiction. Bennett [v. Spear], 520 U.S. [154] at 163, 117 S.Ct. 1154 [(1997)]; Warth, 422 U.S. at 499, 95 S.Ct. 2197. Like its constitutional counterpart, prudential standing establishes three conditions a party must overcome before invoking federal court jurisdiction. First, a plaintiff must assert his "own rights, rather than those belonging to third parties." Sac & Fox Nation [of Missouri v. Pierce], 213 F.3d [566] at 573 [(10th Cir. 2000)]; see also Warth, 422 U.S. at 499, 95 S.Ct. 2197 (explaining that a plaintiff "cannot rest his claim to relief on the legal rights or interests of third parties").

Board of County Commissioners of Sweetwater County v. Geringer, 297 F.3d 1108, 1112 (10th Cir. 2002).

The complaint, ¶4(h) alleges that Defendant diverted revenue from the business by using the business to purchase inventory for her separate business, and by registering sales of the business as sales attributable to her separate business. Paragraph 6 alleges that these diversions of revenues and inventory is a violation of her fiduciary duty of loyalty and trust to the plaintiffs. In Plaintiff's Memorandum in Opposition to Defendant's Motion for Summary Judgment, doc. 16, at 9, Plaintiffs argue that Schueller, as a member of the business, was damaged as a result of breach to the entity; and that Defendant, who owed a fiduciary duty to the company, purposely and willfully misdirected money that was intended to go to the business into her own business pursuits, "causing injury to the members" of the business. These appear to be "derivative claims." "Generally, a derivative claim is one brought on behalf of a legal entity, such as a corporation or partnership to assert a right belonging to [that entity] or to redress a wrong done to it. Recovery generally goes to the entity harmed, rather than to individuals." Losey v Norwest Bank of New Mexico, N.A. (Matter of Norwest Bank of New Mexico, N.A.), 134 N.M. 516, 524-25, 80 P.3d 98, 106-07 (Ct. App.), cert. denied, 134 N.M. 723, 82 P.3d 533 (2003) (Citations and internal punctuation

omitted.); Meyer v. Fleming (In re Chicago, R.I. & P. Ry. Co.), 327 U.S. 161, 167 (1946):

> [Stockholders' derivative suits] are likewise suits to enforce a corporate claim. They are one of the remedies which equity designed for those situations where the management through fraud, neglect of duty or other cause declines to take the proper and necessary steps to assert the rights which the corporation has. The stockholders are then allowed to take the initiative and institute the suit which the management should have started had it performed its duty. The corporation is a necessary party. City of Davenport v. Dows, 18 Wall. 626, 21 L.Ed. 938. Hence, it is joined as a defendant. But it is only nominally a defendant, since any judgment obtained against the real defendant runs in its favor.

(Footnote omitted.)

"Whether a complainant is the real party in interest under state law is generally resolved by inquiring whether he or she has standing under state law." Swanson v. Bixler, 750 F.2d 810 (10th Cir. 1984). Therefore, the Court will look to New Mexico cases to determine if Plaintiffs have standing under state law to assert these claims. The general rule in New Mexico is that a real party in interest is one who owns the right being enforced or who is in a position to discharge the defendant from liability. Moody v. Stribling, 127 N.M. 630, 634, 985 P.2d 1210, 1214 (Ct. App.), cert. denied, 127 N.M. 389, 981 P.2d 1207 (1999)(citing Edwards v. Mesch, 107 N.M. 704, 706, 763 P.2d 1169, 1171 (1988)).

In New Mexico, a partnership is an entity distinct from its partners. § 54-1A-201 NMSA 1978. Property acquired by a partnership is property of the partnership and not of the partners individually. § 54-1A-203 NMSA 1978. Property is presumed to be partnership property if purchased with partnership assets. § 54-1A-204(c) NMSA 1978. A partner is not a co-owner of partnership property and has no interest in partnership property. § 54-1A-501 NMSA 1978. A partner has a duty to the partnership to account for and hold as trustee any property, profit or benefit derived by the partner from a use of partnership property. § 54-1A-404(b)(1) NMSA 1978. A partnership may maintain an action against a partner for a breach of the partnership agreement or for the violation of a duty to the partnership. § 54-1A-405(a) NMSA 1978. A partner may maintain an action against the partnership or another partner to enforce the partner's individual rights. § 54-1A-405(b) NMSA 1978.

These statutes suggest that the Plaintiffs are not the proper parties to assert damages for the alleged diversions of inventory or revenues. The complaint clearly states that it was the business' property that was being used for Defendant's sole proprietorship. Plaintiffs had no direct interest in this property. Defendant had a duty to the business to

account and hold the property, profit or benefit as trustee for the business. And, the business can bring an action against Defendant. Plaintiffs are not in a position to discharge Defendant from liability to the business. See Fate, 130 N.M. at 509, 27 P.3d at 996:

> It is well settled in New Mexico that shareholders of a corporation may bring a derivative action on behalf of the corporation to assert a right belonging to the corporation or to redress a wrong done to it. Marchman v. NCNB Tex. Nat'l Bank, 120 N.M. 74, 81-83, 898 P.2d 709, 717-18 (1995). Similarly, our Supreme Court has stated the same principle in the context of a general partnership:
>
> > [A] partnership is empowered to sue or to be sued in the name of the partnership, and a cause of action accruing to the partnership, for damages to partnership property or interests, belongs to the partnership rather than to individual partners. For these reasons, a partner cannot bring suit as an individual on a claim belonging to the partnership.
>
> First Nat'l Bank v. Sanchez, 112 N.M. 317, 325, 815 P.2d 613, 621 (1991) (citations omitted). New Mexico has recently reiterated the principle that when an action is brought to enforce a right belonging to, or redress a wrong done to, a partnership, the action should be brought derivatively in the partnership's name. GCM, Inc. [v. Kentucky Central Life Ins. Co.], 1997-NMSC-052, ¶¶ 19-20, 24-27, 124 N.M. 186, 947 P.2d 143 (stating that if a duty is owed to the partnership, then only the partnership can sue for a breach of such duty).

Under Federal Rule 17(a) the Court will allow Plaintiffs to amend their complaint to include the real party in

interest[12] if they decide to pursue litigation of the diversion

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[12] This discussion is also applicable if it turns out that the LLC was organized. LLC's are separate legal entities. § 53-19-10(A) NMSA 1978. Property acquired by an LLC is property of the LLC and not of the members, and the members have no interest in LLC property. § 53-19-29(A) NMSA 1978. Property is presumed to be LLC property if it is purchased with LLC funds. § 53-19-29(E) NMSA 1978. A managing member or a manager must account to the LLC and hold as trustee for it any profit or benefit derived from use of the LLC's property. § 53-19-16(D)(2) NMSA 1978. Suits can be brought by or against an LLC in its own name. § 53-19-57 NMSA 1978. A member of an LLC is not a proper party to a proceeding by or against the LLC unless the object is to enforce the member's right against or liability to the LLC. § 53-19-14 NMSA 1978. Suits on behalf of an LLC may be brought "in the name of the" LLC by authorized members or managers. § 53-19-58 NMSA 1978. These statutes suggest that members of LLC's cannot sue individually for LLC claims. While New Mexico courts have not yet addressed this issue, other jurisdictions so find. See, e.g., General Technology Applications, Inc. v. Exro LTDA, 388 F.3d 114, 119 (4th Cir. 2004)(Member of LLC could not enforce LLC's rights for member individually; "Virginia strictly adheres to the derivative-claim rule."); Paclink Communications Int'l, Inc. v. Superior Court of Los Angeles County, 90 Cal.App.4th 958, 964, 109 Cal.Rptr.2d 436, 440 (Ct. App. 2001):

> In this case, the essence of plaintiffs' claim is that the assets of PacLink-1 were fraudulently transferred without any compensation being paid to the LLC. This constitutes an injury to the company itself. Because members of the LLC hold no direct ownership interest in the company's assets (Corp. Code, § 17300), [That section provides: "A membership interest and an economic interest in a limited liability company constitute personal property of the member or assignee. A member or assignee has no interest in specific limited liability company property."] the members cannot be directly injured when the company is improperly deprived of those assets. The injury was essentially a diminution in the value of their membership interest in the LLC occasioned by the

(continued...)

claims as derivative claims.

b. Embezzlement.

> "Embezzlement, for purposes of 11 U.S.C. § 523 'is the fraudulent appropriation of property by a person to whom such property has been entrusted, or into whose hands it has lawfully come, and it requires fraud in fact, involving moral turpitude or intentional wrong, rather than implied or constructive fraud.' " United States Life Title Insurance Co. v. Dohm (In re Dohm), 19 B.R. 134, 138 (Bankr. N.D. Ill.1982) (quoting American Family Insurance Group v. Gumieny (In re Gumieny), 8 B.R. 602, 605 (Bankr. E.D. Wis.1981)).

Driggs v. Black (In re Black), 787 F.2d 503, 507 (10th Cir. 1986). A debtor may not discharge a debt, pursuant to Section 523(a)(4), based on fraud or defalcation which arose while he or she was acting in a fiduciary capacity, or embezzlement or larceny whether or not he or she was acting in a fiduciary capacity. Merrywell v. Barwick (In re Barwick), 24 B.R. 703, 705 (Bankr. E.D. Va. 1982).

The complaint in this case states a cause of action for embezzlement. It alleges transfers of funds to Defendant to be used for a specific purpose, and intentional misuse of

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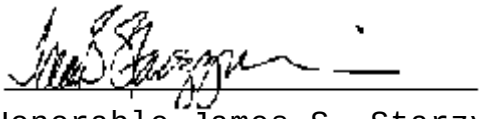
[12](...continued)
loss of the company's assets. Consequently, any injury to plaintiffs was incidental to the injury suffered by PacLink-1.
(Holding that trial court demurrer should be sustained because plaintiffs had no standing to sue other than by a derivative action. Id. at 966-67, 109 Cal.Rptr.2d at 442.)

those funds for Defendant's own purposes. The embezzlement claims will not be dismissed.

CONCLUSION

For the reasons set forth above, the Court will enter an order (1) Denying that portion of Defendant's Motion for Summary Judgment on the grounds of res judicata or collateral estoppel, (2) Denying that portion of Defendant's Motion for Summary Judgment under Rule 9(b), (3) Granting that portion of Defendant's Motion that seeks dismissal of the Section 523(a)(4) claim regarding fraud or defalcation in a fiduciary capacity, (4) Giving Plaintiffs 30 days to take steps to bring into this action the real party in interest regarding claims for diversions of revenues and sales, and (5) Denying Defendant's Motion that seeks dismissal of the Section 523(a)(4) claims regarding embezzlement.



Honorable James S. Starzynski
United States Bankruptcy Judge

I hereby certify that on March 16, 2005, a true and correct copy of the foregoing was electronically transmitted, faxed, delivered, or mailed to the listed counsel and/or parties.

Matthew P Holt
PO Box 2699
Las Cruces, NM 88004-2699

Steve H Mazer
122 10th St NW
Albuquerque, NM 87102-2901