**FILED**
**U.S. Bankruptcy Appellate Panel of the Tenth Circuit**

**February 2, 2011**

**Blaine F. Bates**
**Clerk**

NOT FOR PUBLICATION

**UNITED STATES BANKRUPTCY APPELLATE PANEL**

**OF THE TENTH CIRCUIT**

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| IN RE JEFFREY EDWARD MUSGRAVE, doing business as J&M Construction, member J&M Construction, LLC, and MARIA MUSGRAVE,<br><br>Debtors. | BAP No. CO-10-049 |
| DELMY HERNANDEZ,<br><br>Plaintiff – Appellee,<br><br>v.<br><br>JEFFREY EDWARD MUSGRAVE and MARIA MUSGRAVE,<br><br>Defendants – Appellants. | Bankr. No. 08-25165<br>Adv. No. 09-01006<br>Chapter 7<br><br>OPINION* |

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Appeal from the United States Bankruptcy Court
for the District of Colorado

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Before CORNISH, Chief Judge, KARLIN, and SOMERS, Bankruptcy Judges.

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SOMERS, Bankruptcy Judge.

Jeffrey Musgrave and Maria Musgrave (collectively "Debtors" or "the Musgraves") appeal the bankruptcy court's order granting judgment in favor of Delmy Hernandez on her nondischargeability complaint and the order denying their motion for new trial, or alternatively, to amend the judgment. After oral arguments and careful review of the record before us, we affirm in part, reverse in

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* This unpublished opinion may be cited for its persuasive value, but is not precedential, except under the doctrines of law of the case, claim preclusion, and issue preclusion. 10th Cir. BAP L.R. 8018-6.

part, and remand in part for further proceedings in conformance with this decision.

## I. FACTUAL BACKGROUND

Delmy Hernandez ("Hernandez") owns and operates Pancho's Mexican Restaurant located in California. Jeffrey Musgrave was the sole owner and member/manager of J & M Construction, LLC ("J&M"), a California LLC formed in 2007. In April 2007, Hernandez hired J&M to remodel her restaurant (the "Project").

In August 2008, after having received full payment for the Project, Jeffrey Musgrave moved to Colorado. Maria Musgrave had moved to Colorado earlier, in February 2008.

In March 2008, the Musgraves purchased a Colorado house on Garfield Street ("the Garfield House") for $100,000 with an acquisition loan from the local Mountain Valley Bank. They placed title solely in Maria Musgrave's name. They also obtained a loan, in the approximate amount of $35,000,[1] to remodel the Garfield House, which had been bought out of foreclosure and was "in shambles" when purchased.[2]

In September 2008, within eight weeks of Jeffrey Musgrave moving to Colorado, the Musgraves filed for bankruptcy. They listed Hernandez as a

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[1] The evidence regarding the exact amount of the remodeling loan was unclear. Jeffrey Musgrave testified that he obtained a $30,000 loan to remodel and then a personal loan for $10,000, but $5,000 was for "loan fees or stuff like that." *April 1, 2010, Trial Transcript* ("*Trial Tr.*") at 100, *in* Appellee's Supplemental Appendix ("Supp. App.") at 190, *ll*. 18-19. The bankruptcy court found that "a portion of the remodeling funds, approximately $35,000, was derived from a loan received from Mountain Valley Bank." *Memorandum Opinion and Order dated April 20, 2010* ("*Judgment Opinion*"), *Findings of Fact* at 7, ¶ 36, *in* Appellants' Appendix ("App.") at 57. Because the record supports this finding, we accept it. *See* Fed. R. Bankr. P. 8013.

[2] At the time of the trial, the Garfield House was being leased to a third party for $1,300 a month and was on the market with a sale price of $185,000. *Judgment Opinion* at 7, ¶ 37, *in* App. at 57.

creditor. Hernandez filed an adversary complaint against the Musgraves in January 2009,[3] alleging six (6) claims. Claim 1 was for fraud or defalcation while acting in a fiduciary capacity, Claim 2 was for fraud or defalcation while acting in a fiduciary capacity based on a corporate veil piercing theory, Claim 3 was for theft, Claim 4 was for embezzlement, Claim 5 was for deceptive trade practices, and Claim 6 was for willful and malicious injury. Hernandez relied on 11 U.S.C. § 523(a)(4)[4] for Claims 1 through 5, and on § 523(a)(6) for the last claim.

Hernandez alleged that the Musgraves took money she gave J&M to purchase materials and pay for labor on the Project and skipped town without completing the Project or paying various subcontractors who worked on the Project. Numerous subcontractors who worked on the Project subsequently demanded payment from Hernandez and ultimately filed liens against Hernandez's restaurant, forcing Hernandez to file for Chapter 13 bankruptcy.

Following a trial on the merits, the bankruptcy court issued a partial ruling from the bench and requested Hernandez's counsel to submit proposed findings of fact and conclusions of law. The bankruptcy court concluded that a fraud had been perpetrated and all of the elements of common law fraud had been established, although a common law fraud claim under § 523(a)(2) had never been pled.[5] The bankruptcy court found that Jeffrey Musgrave devised "a clever pattern and scheme" to defraud Hernandez and that both he and Maria Musgrave

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[3] *Complaint to Determine Dischargeability of Debt* ("*Complaint*"), *in* App. at 12-20.

[4] All future references to "Section" or "§" refer to the Bankruptcy Code, Title 11 of the United States Code, unless otherwise noted.

[5] *Trial Tr.* at 132, *ll.* 12-15, *in* Supp. App. at 222 ("Now, the recital I just made encompasses all of the elements of common law fraud, and I conclude that there was a fraud perpetrated here. 523(a)(2) was not pled, but the elements were certainly there. . ."); *Judgment Opinion, Findings of Fact* at 4, ¶ 33, *in* App. at 54.

implemented the plan.[6] The bankruptcy court granted judgment against Jeffrey Musgrave on all six claims, judgment against Maria Musgrave for embezzlement, theft, and willful and malicious injury (Claims 3, 4, and 6), and awarded Hernandez a nondischargeable money judgment in the total amount of $159,236.85, plus interest and costs in an amount to be determined.[7] The bankruptcy court also placed a constructive trust on the Garfield House in favor of Hernandez and ordered Maria Musgrave to execute and deliver a quitclaim deed on the property to Hernandez within seven days after the judgment became final.

Debtors filed a timely Motion for New Trial or, Alternatively, To Amend the Judgment. The bankruptcy court denied that motion on July 6, 2010, describing the relief requested as "nothing more than a second bite at the apple."[8] Debtors timely appealed the judgment against them and the order denying their motion for new trial.

## II. APPELLATE JURISDICTION

This Court has jurisdiction to hear timely filed appeals from final judgments and orders of bankruptcy courts with the Tenth Circuit, unless one of the parties elects to have the district court hear the appeal.[9] Neither party elected

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[6] *Trial Tr.* at 134, *ll.* 1-5, *in* Supp. App. at 224 ("I conclude, and the evidence to me is overwhelming, that there was designed here a clever pattern and scheme devised by Mr. Musgrave, and assuredly, most certainly implemented by Mr. Musgrave and Ms. Musgrave.").

[7] *See Judgment Opinion*, *in* App. at 51-60; *Final Judgment*, *in* App. at 61-62. Although the bankruptcy court observed that all of the elements for a common law fraud claim under § 523(a)(2) were present, it did not enter judgment against either of the Musgraves under that subsection.

[8] *Order Denying Defendants' Motion for New Trial, or, Alternatively, [to] Amend the Judgment (Docket # 69)* ("*Order Denying Motion for New Judgment*") at 2, *in* App. at 69.

[9] 28 U.S.C. § 158(a)(1), (b)(1) and (c)(1); Fed. R. Bankr. P. 8002; 10th Cir. BAP L.R. 8001-3.

to have this appeal heard by the United States District Court for the District of Colorado. The parties have therefore consented to appellate review by this Court. Debtors filed their notice of appeal within fourteen days of the bankruptcy court's Order Denying the Motion for New Judgment, and therefore the appeal was timely.[10]

## III. STANDARD OF REVIEW

"For purposes of standard of review, decisions by judges are traditionally divided into three categories, denominated questions of law (reviewable *de novo*), questions of fact (reviewable for clear error), and matters of discretion (reviewable for 'abuse of discretion')."[11] *De novo* review requires an independent determination of the issues, giving no special weight to the bankruptcy court's decision.[12] A factual finding is "clearly erroneous" when "it is without factual support in the record, or if the appellate court, after reviewing all the evidence, is left with the definite and firm conviction that a mistake has been made."[13] "Under the abuse of discretion standard: 'a trial court's decision will not be disturbed unless the appellate court has a definite and firm conviction that the lower court made a clear error of judgment or exceeded the bounds of permissible choice in the circumstances.'"[14] The standard of review applicable to each error alleged by the debtors will be identified below on an issue-by-issue basis.

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[10] Fed. R. Bankr. P. 8002(b).

[11] *Pierce v. Underwood*, 487 U.S. 552, 558 (1988); *see* Fed. R. Bankr. P. 8013; *Fowler Bros. v. Young (In re Young )*, 91 F.3d 1367, 1370 (10th Cir. 1996).

[12] *Salve Regina Coll. v. Russell*, 499 U.S. 225, 238 (1991).

[13] *Las Vegas Ice & Cold Storage Co. v. Far W. Bank*, 893 F.2d 1182, 1185 (10th Cir. 1990) (internal quotation marks omitted).

[14] *Moothart v. Bell*, 21 F.3d 1499, 1504 (10th Cir.1994) (quoting *McEwen v. City of Norman*, 926 F.2d 1539, 1553-54 (10th Cir.1991)).

## IV. DISCUSSION

Debtors argue the bankruptcy court erred in four ways: (1) entering judgment against Maria Musgrave; (2) entering judgment against Debtors for fraud under § 523(a)(4) when no such claim was raised; (3) determining the damages to repair construction defects to be nondischargeable; and (4) imposing a constructive trust upon real estate owned by Maria Musgrave and ordering her to convey her interest in that property to Hernandez when that relief was never expressly sought.

### A. The Judgment Against Maria Musgrave

#### 1. The bankruptcy court did not abuse its discretion in concluding that Maria Musgrave had notice of the allegations against her.

Debtors argue that the bankruptcy court erroneously rendered judgment against Maria Musgrave because "[n]one of the allegations in the six counts [referenced her]."[15] Maria Musgrave claims she was misled and prejudiced into believing that Hernandez only sought relief against her husband. She contends that "since [Hernandez] never requested the pleadings be amended[,] she was not given the opportunity to object to any such amendment or put on any evidence on her behalf."[16]

We review claims of error based on allegations of surprise and failure to plead for an abuse of discretion.[17] In the Order Denying Motion for New

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[15] Appellants' Brief at 5.

[16] *Id.* at 5.

[17] *In Matter of Schwager*, 121 F.3d 177, 187 (5th Cir. 1997). The parties did not specifically brief what standard this Court should apply when reviewing the bankruptcy court's construction of the pleadings. Rulings regarding pleadings are generally matters within the court's discretion and thus reviewed for abuse of discretion. *See Foman v. Davis*, 371 U.S. 178, 182 (1962) (decisions regarding leave to amend pleadings within the discretion of the district court); *GWN Petroleum Corp. v. Ok-Tex Oil & Gas, Inc.*, 998 F.2d 853, 858 (10th Cir. 1993) (rulings regarding amendment of pleadings reviewed for abuse of discretion); *Hardin v. Manitowoc-Forsythe Corp.*, 691 F.2d 449, 457 (10th Cir. 1982)

(continued...)

Judgment, the bankruptcy court concluded that Maria Musgrave received actual notice of the claims against her.[18] We agree.

The Complaint specifically named Maria Musgrave a co-defendant. She received service of process. She participated in the case by filing an answer, responding to written discovery, and asserting a denial in the parties' joint pretrial statement. Although the Complaint failed to specifically refer to Maria Musgrave in its text,[19] subsequent pleadings and correspondence between the parties' attorneys sufficiently outlined the allegations and the relief sought against her and provided Maria Musgrave notice of the claims against her.

In the parties' joint Pretrial Statement, filed in December 2009, Hernandez alleged that "Musgrave failed to pay subcontractors out of funds paid to Musgrave by the Plaintiff, used the Plaintiff's money for self-dealing purposes unrelated to the Plaintiff's construction project, and has attempted to defraud the Plaintiff of her money in filing for bankruptcy."[20] She also alleged that "Musgrave abandoned construction on the Plaintiff's property without warning and intentionally defrauded the Plaintiff of her money, by falsely and intentionally representing to the Plaintiff that Musgrave had been paid in full, and by falsely

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[17] (...continued)
(whether parties have impliedly consented to trial of an unpleaded issue under Rule 15(b) is subject to review for abuse of discretion); *Joseph Mfg. Co. v. Olympic Fire Corp.*, 986 F.2d 416, 418 (10th Cir. 1993) (district court's decision on a motion to modify a pretrial order reviewed for abuse of discretion); *In re Rafter Seven Ranches L.P.*, 546 F.3d 1194, 1200 (10th Cir. 2008) (abuse of discretion standard of review applied to bankruptcy court's decision to allow issue allegedly not identified in the pretrial order or other pleadings to be considered in deciding the case).

[18] *Order Denying Motion for New Judgment* at 3, *in* App. at 70.

[19] Maria Musgrave's name appears only once in the entire nine page Complaint, and it is in the caption: "Jeffrey Edward Musgrave and Maria Musgrave, dba J&M Construction, and mem. J&M Construction, LLC and High Desert Custom Patios, Defendant [sic]." *Complaint* at 1, *in* App. at 12.

[20] *Pretrial Statement*, *in* Supp. App. at 78.

and intentionally representing that Musgrave would pay all subcontractors in full."[21] Hernandez denominated "Musgrave" in the Joint Pretrial Statement to refer to both Jeffrey and Maria Musgrave, thus directing a person to consider any allegations regarding "Musgrave" to include Maria Musgrave.[22]

In a letter to Debtors' counsel, dated February 20, 2010, Hernandez's counsel outlined how Debtors' bank records and bankruptcy documents "reveal[ed] a pattern of willful fraud by both Jeff and Maria Musgrave which was designed to defraud not only Delmy Hernandez, but also the U.S. Trustee, the Bankruptcy Court, and the Internal Revenue Service."[23] The letter described Maria Musgrave's role in the scheme as follows:

> Maria Musgrave moved to Colorado and immediately gained a job as a bank teller at Mountain Valley Bank. Once in place there, she opened several Mountain Valley bank accounts for herself and her husband. Her employment there enabled her to accomplish the task of gradually depositing $57,000 in *cash* brought from California without arousing the suspicions of any banking personnel, since she could personally accomplish the cash deposits into her own accounts.[24]

The letter further noted that despite having over $147,000 in cash, Maria and Jeffrey Musgrave filed for Chapter 7 relief, reported that they had no cash on hand and no money in their banking accounts, and concealed the existence of at least one bank account from their creditors.[25] Given the letter and the Joint Pretrial Statement, the bankruptcy court did not abuse its discretion in construing

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[21] *Id.*

[22] The Complaint had denominated "Musgrave" to refer only to Defendant Jeffrey Edward Musgrave, dba J& M Construction, mem. J&M Construction, L.L.C. *See Complaint, Parties, Jurisdiction and Venue* at 1, ¶ 2, *in* App. at 12. Hernandez's Supplemental Pretrial Statement dated January 11, 2010, also denominated "Musgrave" to refer only to Jeffrey Musgrave.

[23] *Letter dated February 20, 2010, in* Supp. App. at 88.

[24] *Id.* at 89.

[25] *Id.*; *Schedule B, in* Supp. App. at 17.

Hernandez's pleadings to broadly accuse Maria Musgrave of being a knowing accomplice to her husband's plan to defraud Hernandez.

Debtors' argument that Maria Musgrave lacked an opportunity to object is unpersuasive. She could have filed a motion to dismiss pursuant to Federal Rule of Civil Procedure[26] 12(b)(6), a Rule 12(e) motion for a more definite statement, or a Rule 21 misjoinder motion. Maria Musgrave elected to file none of these pretrial motions to clarify what claims were being asserted against her.

Instead, she elected to raise this issue for the first time in her counsel's opening statement at trial, apparently pursuant to Rule 12(c), when he requested judgment on the pleadings.[27] At that point, Debtors' counsel argued that Maria Musgrave was entitled to judgment on the pleadings, as a matter of law, because "there is (sic) no allegations in that complaint at all that relate to Maria Musgrave."[28]

We agree with the bankruptcy court that Maria Musgrave cannot claim a missed opportunity to object to the Complaint after having failed to utilize the multiple procedural tools available to her. Thus, to the extent that the "no allegations against me" argument is an attack on the bankruptcy court's implicit denial of her request for judgment on the pleadings, it is unavailing.

This Court reviews a bankruptcy court's denial of a motion for judgment on the pleadings *de novo*, applying the same standard applicable to a Rule 12(b)(6)

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[26] All future references to "Rule" shall refer to the Federal Rules of Civil Procedure, unless otherwise noted.

[27] Rule 12(c) provides that a party may move for judgment on the pleadings after the pleadings are closed, but early enough not to delay trial. Ordinarily, a motion for judgment on the pleadings should be made promptly after the close of the pleadings, which generally is after an answer is filed. 5C Charles Alan Wright & Arthur R. Miller, *Federal Practice and Procedure Civil* § 1367 at 215 (3d ed. 2004).

[28] *Trial Tr.* at 15, *ll.* 6-7, and 124, *ll.* 12-13, *in* Supp. App at 105 and 214.

motion.[29] "Judgment on the pleadings should not be granted 'unless the moving party has clearly established that no material issue of fact remains to be resolved and the party is entitled to judgment as a matter of law.'"[30] Because the extent of Maria Musgrave's participation in the scheme against Hernandez was in dispute, the bankruptcy court properly denied Maria Musgrave's oral motion for judgment on the pleadings before presentation of the evidence.

2. The bankruptcy court erred in entering judgment against Maria Musgrave.

We now consider the merits of the judgment against Maria Musgrave. The bankruptcy court found Maria Musgrave liable to Hernandez for embezzlement and larceny under § 523(a)(4), and for willful and malicious injury under § 523(a)(6). Maria Musgrave argues that there is no evidence to support the judgment against her.[31]

The Bankruptcy Code's central purpose is to "provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy 'a new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.'"[32] In furtherance of the "fresh start" policy, "[e]xceptions to discharge are construed narrowly, and the burden of proving that a debt falls within a statutory exception

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[29] *McHenry v. Utah Valley Hosp.*, 927 F.2d 1125, 1126 (10th Cir. 1991).

[30] *Park Univ. Enters., Inc. v. Am. Cas. Co. of Reading, PA*, 442 F.3d 1239, 1244 (10th Cir. 2006) (quoting *United States v. Any & All Radio Station Transmission Equip.*, 207 F.3d 458, 462 (8th Cir. 2000)).

[31] Maria Musgrave also argued that there was no evidence that she had a fiduciary relationship with Hernandez. Because the bankruptcy court did not find Maria Musgrave liable based on a fiduciary theory under § 523(a)(4), we need not address her argument that there was no evidence to support those claims.

[32] *Grogan v. Garner*, 498 U.S. 279, 286 (1991) (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934)).

is on the party opposing discharge."[33] Discharge, however, is only for "the honest, but unfortunate debtors."[34] Generally, creditors must prove the nondischargeability of their claim by a preponderance of the evidence standard.[35]

a. Embezzlement and larceny under § 523(a)(4).

Embezzlement, under § 523(a)(4), is the fraudulent appropriation of property by a person to whom such property has been entrusted or into whose hands it has lawfully come.[36] The elements required to prove embezzlement are: (1) entrustment, (2) of property (3) of another (4) that is misappropriated (used or consumed for a purpose other than for which it was entrusted), (5) with fraudulent intent.[37] Black's Law Dictionary defines larceny as "[t]he unlawful taking and carrying away of someone else's personal property with the intent to deprive the possessor of it permanently."[38] A leading treatise defines larceny as "the fraudulent and wrongful taking and carrying away of the property of another with intent to convert the property to the taker's use without the consent of the owner."[39] Larceny and embezzlement differ primarily as to whether or not the debtor originally obtained property of another lawfully. Embezzled property is originally obtained in a lawful manner, while in larceny the property is unlawfully

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[33] *Driggs v. Black (In re Black)*, 787 F.2d 503, 505 (10th Cir. 1986), *abrogated on other grounds by Grogan*, 498 U.S. at 286 (on proper burden of proof).

[34] *Grogan*, 498 U.S. at 286-287 (quoting *Local Loan Co.*, 292 U.S. at 244).

[35] *Id.* at 290-291.

[36] *Klemens v. Wallace (In re Wallace)*, 840 F.2d 762, 765 (10th Cir. 1988); *Tulsa Spine Hosp., LLC v. Tucker (In re Tucker)*, 346 B.R. 844, 852 (Bankr. E.D. Okla. 2006).

[37] *Tucker*, 346 B.R. at 852; *Bryant v. Tilley (In re Tilley)*, 286 B.R. 782, 789 (Bankr. D. Colo. 2002).

[38] *Black's Law Dictionary* 885 (7th ed. 1999).

[39] 4 *Collier on Bankruptcy* ¶ 523.10[2], 523-77 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009).

obtained.[40]

The bankruptcy court's legal conclusions under § 523(a)(4) are reviewed *de novo*.[41] The bankruptcy court's factual findings, including those concerning intent, are reviewed under the clearly erroneous standard.[42]

With respect to Maria Musgrave, the bankruptcy court found that (1) she moved to Colorado, without her husband, in February 2008, to assist in establishing residency for a planned bankruptcy filing in September 2008; (2) she obtained employment as a bank teller at Mountain Valley Bank in Meeker, Colorado; (3) she (and Jeffrey Musgrave) opened two bank accounts in Meeker, Colorado at Mountain Valley Bank in March of 2008, in their names and in the name of J&M; (4) she (and Jeffrey Musgrave) purchased the Garfield House and titled it solely in her name to shield the property and defraud their creditors, (5) during the period from July 2008 through December 2008, she (and Jeffrey Musgrave) made repeated and consistent large cash deposits to their business and personal accounts; (6) she (and Jeffrey Musgrave) failed to disclose the existence of one of their bank accounts in their bankruptcy case; and (7) she (and Jeffrey Musgrave) transferred $18,400 to the undisclosed bank account in November 2008.[43] Regarding the cash deposits, the bankruptcy court found "no logical or credible evidence to indicate any source of those cash funds other than the construction payments made by Hernandez."[44] The bankruptcy court also concluded that the Musgraves must have used Hernandez's money to remodel

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[40] *Id.*; *Tucker*, 346 B.R. at 852; *Tilley*, 286 B.R. at 789.

[41] *Fowler Bros. v. Young (In re Young)*, 91 F.3d 1367, 1371 (10th Cir. 1996) (determination under section 523(a)(4) reviewed *de novo*).

[42] *See Holaday v. Seay (In re Seay)*, 215 B.R. 780, 788 (10th Cir. BAP 1997).

[43] *Judgment Opinion, Findings of Fact* at 4, ¶¶ 26-29, and 5, ¶ 35i-o, *in* App. at 54 and 56-57.

[44] *Id.* at 6, ¶ 35m, *in* App. at 56.

their Colorado home.[45]

After reviewing all the evidence, we conclude the bankruptcy court erred in concluding Maria Musgrave committed larceny or embezzlement. Although the bankruptcy court made no findings regarding the lawfulness of the original taking of the funds, the record shows that Hernandez entrusted her money to Jeffrey Musgrave pursuant to a contract. Thus, the funds were originally obtained lawfully, and hence there can be no larceny. Moreover, there was no evidence, nor findings, that Maria Musgrave in any way participated in the original taking.

There is likewise no evidence in the record to support the bankruptcy court's finding that Maria Musgrave intended to deprive Hernandez of her money. In fact, there is no evidence that Maria Musgrave participated in the operation of J&M, knew anything whatsoever about its contracts or finances, or was even aware of the existence of the Hernandez job, let alone her husband's failure to pay subcontractors on that job. Therefore, the only way that the bankruptcy court could have concluded that Maria Musgrave had any intent toward Hernandez was to impute Jeffrey Musgrave's wrongful intent to his wife, based simply on the existence of a marital relationship.

"Courts have generally held that fraudulent intent may not be imputed from one spouse to another based simply on the marital relationship of the parties."[46] In *Tsurukawa*, the court held that a marital union alone, without a finding of a partnership or other agency relationship between spouses, cannot serve as a basis for imputing fraud from one spouse to the other.[47]

Evidence that Maria Musgrave moved to Colorado, bought a home,

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[45] *Id.* at 7, ¶ 36, *in* App. at 57.

[46] *Synod of S. Atl. Presbyterian Church v. Magpusao (In re Magpusao)*, 265 B.R. 492, 498 (Bankr. M.D. Fla. 2001) (collecting cases); *In re Tsurukawa*, 258 B.R. 192 (9th Cir. BAP 2001).

[47] *Tsurukawa*, 258 B.R. at 198.

obtained a job as a bank teller, opened bank accounts, made cash deposits into those accounts, and ultimately filed for bankruptcy, even taken together, fails to establish Maria Musgrave's knowledge or participation in her husband's embezzlement of Hernandez's money. Indeed, the record is barren of evidence connecting Maria Musgrave personally to the embezzlement, or even that she was aware that her husband was embezzling from Hernandez. While there was evidence that Maria Musgrave made several large cash deposits into the Musgrave bank accounts, there was no evidence that she knew the source of the cash deposited, nor of any impropriety in her husband having obtained the cash that he gave her to deposit into their accounts. Absent any such evidence, it is impossible to know whether large cash deposits were the norm in the Musgraves' household dealings. Neither we nor the bankruptcy court can impute a wrongful motive from conduct that is otherwise neutral.

After reviewing the record, we are left with "the definite and firm conviction" that the bankruptcy court erred in finding that Maria Musgrave acted with fraudulent intent. We conclude the bankruptcy court erred in finding Maria Musgrave liable for embezzlement and larceny under § 523(a)(4). The judgment against Maria Musgrave for embezzlement and larceny under § 523(a)(4) must be REVERSED.

b. Willful and malicious injury under § 523(a)(6).

Section 523(a)(6) excepts from discharge any debt "for willful and malicious injury by the debtor to another entity or to the property of another entity."[48] The Tenth Circuit directs this Court to apply the "clearly erroneous" standard on review of a bankruptcy court's ultimate finding of willful and

[48] 11 U.S.C. § 523(a)(6).

malicious injury under § 523(a)(6).[49] Federal Rule of Bankruptcy Procedure 8013 directs this Court to accept the bankruptcy court's findings of fact unless clearly erroneous and to give due regard to the bankruptcy court's assessment of the credibility of the witnesses.[50]

> Section 523(a)(6) requires proof of: (1) an intentional action by the defendant; (2) done with the intent to harm; (3) which causes damage (economic or physical) to the plaintiff; and (4) the injury is the proximate result of the action by the defendant. If a debtor knows that his spouse or significant other is embezzling funds, and then participates in the use or dissipation of them for a purpose other than the intent of the original entrustment to the significant other, then the debtor may be liable for conversion, which is a claim that would satisfy the requirements of a willful and malicious injury to property claim under Section 523(a)(6).[51]

As already noted, there is no evidence establishing that Maria Musgrave was aware of her husband's embezzlement. The bankruptcy court's factual findings demonstrate only her receipt of cash from her husband, which is insufficient to support the conclusion that Maria Musgrave knew or should have known that the money came from Hernandez, or that she knew that her husband's use of it was wrongful, regardless of its source. There simply is no evidence that Maria Musgrave used any funds given to her by her husband with knowledge that the money was anything other than legitimate profit from one of his business ventures.

We conclude the circumstantial evidence insufficient to support a finding that Maria Musgrave intended to cause Hernandez willful and malicious injury. The bankruptcy court erred in finding Maria Musgrave liable to Hernandez for

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[49] *In re Pasek*, 983 F.2d 1524, 1528 (10th Cir. 1993).

[50] The bankruptcy court found Hernandez "an extremely credible witness" and her contractor Bob Carlucci "a very credible witness." *Judgment Opinion, Findings of Fact* at 4, ¶ 31, *in* App. at 54. In contrast, the bankruptcy court found Jeff Musgrave's credibility "extremely poor." *Id.* at 4, ¶ 32, *in* App. at 54.

[51] *Bryant v. Tilley (In re Tilley)*, 286 B.R. 782, 790 (Bankr. D. Colo. 2002) (citing *Synod of S. Atl. Presbyterian Church v. Magpusao (In re Magpusao)*, 265 B.R. 492, 498 (Bankr. M.D. Fla. 2001)).

willful and malicious injury under § 523(a)(6). The judgment against Maria Musgrave for willful and malicious injury under § 523(a)(6) must be REVERSED.

Because we are reversing the bankruptcy court's liability determinations as to Maria Musgrave, we will vacate the award of damages as to her.[52] If Maria Musgrave is not liable, it simply follows that damages cannot be assessed against her.

B. The Judgment Against Jeffrey Musgrave

Jeffrey Musgrave also attacks the bankruptcy court's judgment against him. He argues the bankruptcy court erred to the extent it found him liable for fraud under § 523(a)(4) because that claim had not been pled and he did not impliedly consent to try it.[53]

Section 523(a)(4) provides: a discharge . . . does not discharge an individual debtor from any debt – (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny. The use of the disjunctive "or," and the lack of a comma after the word "fraud," indicates the qualifying phrase "while acting in a fiduciary capacity" applies to both fraud and defalcation. The

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[52] *See Mercer Transp. Co. v. Greentree Transp. Co.*, 341 F.3d 1192, 1197 (10th Cir. 2003) (vacating ruling on damages upon reversal on liability); *UPMC Health Sys. v. Metro. Life Ins. Co.*, 391 F.3d 497, 504 (3d Cir. 2004) (vacation of award of damages follows reversal on liability).

[53] The bankruptcy court referenced § 523(a)(2) as the claim not alleged in the Complaint that it considered tried by consent:

> Although the Complaint does not specifically allege a violation of 11 U.S.C. § 523(a)(2), the Court finds that the elements of a common law fraud were satisfied . . . . *See* Bankruptcy Rule 7015 (applying Rule 15(b) to adversary proceedings, which provides in pertinent part that when issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings[.)].

*Judgment Opinion* at 4-5, ¶ 33, *in* App. at 54-55. Because the bankruptcy court did not enter judgment against the Musgraves under that provision, it is not an issue for appeal.

presence of a comma after "while acting in a fiduciary capacity" indicates that the qualifying phrase does not apply to the different categories of misconduct following it.[54] Pursuant to these grammatical rules, § 523(a)(4) excepts from discharge four different types of debts: (1) debts for fraud while acting in a fiduciary capacity ("fiduciary fraud"), (2) debts for defalcation while acting in a fiduciary capacity ("fiduciary defalcation"), (3) debts for embezzlement, and (4) debts for larceny.[55]

Throughout the Complaint, Hernandez repeatedly alleged Debtors' conduct constituted "fraud or defalcation while acting in a fiduciary capacity" pursuant to § 523(a)(4).[56] Accordingly, the bankruptcy court did not abuse its discretion in finding that a cause of action under § 523(a)(4) for fraud while acting in a fiduciary capacity was properly before it.[57]

In any event, any attack on the bankruptcy court's fiduciary fraud judgment would not change the ultimate outcome of this case. The bankruptcy court found Jeffrey Musgrave liable under all four theories of § 523(a)(4). Jeffrey Musgrave elected to limit his appeal of the § 523(a)(4) judgment against him to only the claim that fiduciary fraud was not raised in the pleadings. He specifically did not appeal the judgment against him for fiduciary defalcation, embezzlement, or larceny. As such, the judgment against him on the other theories of liability under § 523(a)(4) remains unchallenged. Accordingly, we will not address this

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[54] 4 *Collier on Bankruptcy* ¶ 523.10[1][d], 523-72 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009) ("The phrase 'while acting in a fiduciary capacity' clearly qualifies the words 'fraud or defalcation' and not 'embezzlement' or 'larceny.'").

[55] *Id.* at 523.10[1], [2].

[56] *See Complaint* at 5-8, ¶¶ 39, 43, 44, 48, 51 and 55, *in* App. at 16-19.

[57] *In re Schwager*, 121 F.3d 177, 186-87 (5th Cir. 1997) (even though complaint did not use the word "defalcation," bankruptcy court did not abuse its discretion in reading pleading in nondischargeability proceeding as raising issue of fiduciary defalcation when claimants cited specific statutory provision).

issue further and affirm the bankruptcy court's liability judgment against Jeffrey Musgrave under § 523(a)(4).[58]

C. The Amount of the Judgment: the Cost to Repair Defective Work

The bankruptcy court awarded Hernandez judgment against both Jeffrey and Maria Musgrave in the total amount of $159,236.85, plus interest and costs to be determined. This number was based on the following: $40,157.90 represented the stipulated amount Hernandez owed to unpaid subcontractors who filed liens against her property, $57,000 represented the cost to repair defective work on the Project ("Repair Cost"), $9,000 represented the cost to complete the patio, and $53,078.95 represented punitive damages.[59] The bankruptcy court declared these debts nondischargeable pursuant to §§ 523(a)(4) and (6).[60]

Jeffrey Musgrave argues the Repair Cost should be a dischargeable debt because "[t]here was no evidence of any willful or intentional act by Musgraves as it related to these defects . . . ."[61] He claims that subcontractors (not Jeffrey Musgrave, himself) did all of the defective work, and that Hernandez would thus have suffered the damages for repair even if Jeffrey Musgrave had not

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[58] *See Orr v. City of Albuquerque*, 417 F.3d 1144, 1154 (10th Cir. 2005) (court will not address issue that has no bearing on the ultimate outcome of the case); *Griffin v. Davies*, 929 F.2d 550, 554 (10th Cir. 1991) (The court "will not undertake to decide issues that do not affect the outcome of a dispute.").

[59] Jeffrey Musgrave contests neither the amount required to repair the defective work nor the cost to complete the patio. Appellants' Opening Brief at 8.

[60] *Judgment Opinion, Conclusions of Law* at 7-9, ¶¶ 1-5 and 7, *in* App. at 57-59. *But see Final Judgment* at 2, ¶ 4, *in* App. at 62 ("actual damages plus exemplary damages in the sum of $159,236.85 . . . . [are] non-dischargeable pursuant to 11 U.S.C. § 523(a)(6)").

[61] Appellants' Opening Brief at 8. At oral argument, Jeffrey Musgrave conceded that the $9,000 cost to complete the patio and the $40,157.90 "unpaid subcontractor" debt are nondischargeable debts.

misappropriated her money.[62] The bankruptcy court rejected this argument, stating it overlooked "the fact that the repair and completion costs are a direct result of the fraud that these Defendants perpetrated against the Plaintiff . . . . [and] while these types of damages are often routine breach of contract damages, the evidence showed that, in this case, they are fully recoverable as compensatory damages resulting from fraud, theft and embezzlement [citing *Cohen v. de la Cruz*, 523 U.S. 213, 222 (1998)]."[63]

In *Cohen*, the debtor charged rents above the levels permitted by a city ordinance and was ordered by the city's rent control administrator to refund $31,382.50 in excess rents to his affected tenants. The debtor did not comply with that order and filed for Chapter 7 relief, seeking to discharge that debt. The tenants filed a nondischargeability complaint, arguing the debt owed to them arose from rent payments obtained by "actual fraud" and was nondischargeable under § 523(a)(2). They also sought treble damages, attorney fees, and costs. Following a bench trial, the bankruptcy court ruled in the tenants' favor and awarded them treble damages, plus reasonable attorney fees and costs. The bankruptcy court held that the treble damages were nondischargeable because they arose out of fraudulent conduct. The debtor appealed and the Third Circuit Court of Appeals affirmed in a divided opinion. The Supreme Court granted certiorari and affirmed.

In construing the phrase "debt for" in § 523(a)(2), the Supreme Court looked to parallel provisions, stating:

> Section 523(a) defines several categories of liabilities that are excepted from discharge, and the words "debt for" introduce many of them, viz., "debt . . . for a tax or a customs duty . . . with respect to which a return . . . was not filed," § 523(a)(1)(B)(i), "debt . . . for fraud or defalcation while acting in a fiduciary capacity,

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62 Appellants' Reply Brief at 2.

63 *Order Denying Motion for New Judgment* at 4, *in* App. at 71.

> embezzlement, or larceny," § 523(a)(4), "debt . . . for willful and malicious injury by the debtor to another entity," § 523(a)(6), and "debt . . . for death or personal injury caused by the debtor's operation of a motor vehicle if such operation was unlawful because the debtor was intoxicated," § 523(a)(9). None of these use "debt for" in the restitutionary sense of "liability on a claim to obtain"; it makes little sense to speak of "liability on a claim to obtain willful and malicious injury" or "liability on a claim to obtain fraud or defalcation." Instead, "debt for" is used throughout to mean "debt as a result of," "debt with respect to," "debt by reason of," and the like, *see American Heritage Dictionary* 709 (3d ed.1992); *Black's Law Dictionary* 644 (6th ed.1990), connoting broadly any liability arising from the specified object, *see Davenport*, *supra*, at 563, 110 S.Ct., at 2133 (characterizing § 523(a)(7), which excepts from discharge certain debts "for a fine, penalty, or forfeiture" as encompassing "debts arising from a 'fine, penalty, or forfeiture'").[64]

The Supreme Court concluded that the phrase "debt for" means "debt arising from" or "debt on account of," and that § 523(a)(2)(A) "is best read to prohibit the discharge of any liability arising from a debtor's fraudulent acquisition of money, property, etc., including an award of treble damages for the fraud."[65] The Supreme Court noted that this conclusion was buttressed by the history of the fraud exception and the policy that the creditors' interest in recovering full payment of debts in these categories outweighs the debtors' interest in a complete fresh start.[66] Although *Cohen* involved a § 523(a)(2) claim, the Supreme Court's analysis of the text and structure of § 523(a) suggest its holding is not limited to § 523(a)(2).

1. Nondischargeable damages under the fraud exception are limited to those proximately caused by the misrepresentations.

*Cohen* requires the alleged fraud proximately cause the debt in order for it to be excepted from discharge.[67] In *In re Creta*, the First Circuit Bankruptcy

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[64] *Cohen*, 523 U.S. at 219-220.

[65] *Id.* at 221.

[66] *Id.* at 222-23.

[67] *See* 4 *Collier on Bankruptcy* ¶ 523.08[1][e], 523-47 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009) (the loss sustained must be the proximate

(continued...)

Appellate Panel referred to the *Restatement (Second) of Torts* (1976) for guidance on the question of causation:

> The *Restatement* explains that proximate causation encompasses two elements, "causation in fact" and "legal causation." *Restatement* §§ 546, 548A. *See also Brown*, 217 B.R. at 862. "Causation in fact" requires that a debtor's misrepresentations be a "substantial factor in determining the course of conduct that results in [the] loss." Restatement § 546.
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> . . .
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> "Legal causation" requires that a creditor's loss "reasonably be expected to result from the reliance." *Id.* § 548A.[68]

In *Scheidelman v. Henderson (In re Henderson)*, the court noted that in cases involving contractor-debtors, there are generally two ways to prove fraud or misrepresentation: (1) show that the debtor entered into the contract with the intent of never complying with the terms, or (2) show that there was an intentional misrepresentation as to a material fact or qualification when soliciting or obtaining the work.[69] Material false representations in connection with a construction contract include promises to obtain the necessary permits, license and insurance, or overstating qualifications.[70] These representations are material because they go to the very essence of the agreement, that is, reliance by the creditor that the debtor has the requisite knowledge, experience, and training to properly complete the work.[71]

Applying these principles, we are not convinced that the Repair Cost is a

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[67] (...continued)
consequence of the representations made); *In re Ophaug*, 827 F.2d 340 (8th Cir. 1987) (same). *See also In re Creta*, 271 B.R. 214, 218 (1st Cir. BAP 2002) (§ 523(a)(2)(A) requires a "direct link" between the alleged fraud and the debt to be discharged).

[68] *Creta*, 271 B.R. at 219.

[69] 423 B.R. 598, 622 (Bankr. N.D.N.Y. 2010).

[70] *Id.* (collecting cases); *Creta*, 271 B.R. at 220-221 (collecting cases).

[71] *Creta*, 271 B.R. at 220-221.

direct result of the fraud Jeffrey Musgrave perpetrated against Hernandez. The misrepresentations in this case were (1) promising to pay subcontractors and failing to do so; (2) lying about the need for payments to be made by cashier's check and in amounts under $10,000.00; and (3) failing to disclose a bank account to hide the misappropriated funds. We do not see how these misrepresentations caused the uneven framing, improper tiling, improper placement of the air conditioning ducts, or the improper electrical wiring, all of which work was performed by subcontractors hired by Jeffrey Musgrave. No evidence was presented regarding whether Jeffrey Musgrave even knew about the defects.[72] Nothing in the record suggests Musgrave purposely or knowingly hired substandard contractors, and nothing in the record establishes a causal connection between Jeffrey Musgrave's misrepresentations and the Repair Cost.

The bankruptcy court found causation based on the rationale that "if the Defendants had not stolen and/or embezzled Plaintiff's payment monies in accordance with their preconceived plan, and had instead used the monies to perform the promised tasks, Plaintiff would not have suffered these consequences (and more)."[73] This rationale is flawed, however, because the construction tasks were actually performed, albeit poorly in many particulars.[74] Instead, the evidence established that Jeffrey Musgrave failed to pay all of the subcontractors

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[72] *Cf. Sinha v. Clark (In re Clark)*, 330 B.R. 702, 705-06 (Bankr. C.D. Ill. 2005) (debt representing the cost to correct problems held nondischargeable under §§ 523(a)(2)(A) and (a)(6) given testimony from subsequent contractor that the work done by debtor clearly showed that it was done only to create the appearance of honoring debtor's contractual obligation). Nothing close to such evidence exists in the record.

[73] *Order Denying Motion for New Judgment* at 4, *in* App. at 71.

[74] The only part of the Project that was left uncompleted was the patio. Jeffrey Musgrave concedes the $9,000 cost to complete the patio is a nondischargeable debt. *But see Sandak v. Dobrayel (In re Dobrayel)*, 287 B.R. 3, 24 (Bankr. S.D.N.Y. 2002) (debt for additional sums that creditor paid to another contractor to complete construction after already paying debtor in full held dischargeable).

who worked on the Project, not that subcontractors were not hired to perform the work. Evidence regarding the defects was limited to their existence and the cost to repair them, but no evidence was presented as to their cause or Debtors' knowledge of them. There was no evidence that Musgrave, himself, did any of the inferior work, and there was no evidence, or even suggestion, that Musgrave purposely hired inept contractors, knowing those contractors would perform shoddy work.

For these reasons, we conclude the bankruptcy court erred in holding that the Repair Cost was a debt resulting from the fraud perpetrated by Jeffrey Musgrave and that it was nondischargeable under the fraud exception, whether under § 523(a)(2) or § 523(a)(4).

2. Nondischargeable damages under the embezzlement and larceny exception are limited to the amount embezzled, the cost to investigate, and punitive damages.

We have located no authority for the proposition that the cost to repair defective work is a compensable damage for embezzlement or larceny. To the contrary, damages for embezzlement and theft claims are generally limited to money or property inappropriately used,[75] the actual cost of accounting fees incurred to discover and verify the sums involved,[76] and punitive damages.[77] The cost of repairing shoddy work does not fit within these categories, nor do we see

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[75] *Brown v. Kuwazaki (In re Kuwazaki)*, 438 B.R. 353, 2010 WL 3706004, at *6 (10th Cir. BAP (2010) (citing *Int'l Fid. Ins. Co. v. Fox (In re Fox)*, 357 B.R. 770, 778 (Bankr. E.D. Ark. 2006)) (only the portion of the property entrusted that is used inappropriately is nondischargeable under § 523(a)(4)); *Telmark, LLC v. Booher (In re Booher)*, 284 B.R. 191, 214 (Bankr. W.D. Pa. 2002) (nondischargeable debt under § 523(a)(4) is limited to amounts actually embezzled).

[76] *Brookman v. Gibson (In re Gibson)*, 77 B.R. 829, 831 (Bankr. D. Colo. 1987).

[77] *Cohen v. de la Cruz*, 523 U.S. 213, 223 (1998) (treble damages are nondischargeable). *See also Ehlenbeck v. Patton (In re Patton)*, 58 B.R. 149 (W.D.N.C. 1986).

any evidence in the record that would support a finding the Repair Cost arose from embezzlement or larceny. We conclude the bankruptcy court erred in determining that the Repair Cost was a compensatory damage that resulted from either larceny or embezzlement and, absent such evidence, these damages cannot be held nondischargeable under the embezzlement or larceny exceptions.

3. Nondischargeable damages under the willful and malicious injury exception are limited to injuries that were desired or anticipated by the debtor.

In *Kawaauhau v. Geiger*,[78] the Supreme Court established guidelines for determining whether a debt arises from a willful and malicious injury and, therefore, is excepted from discharge under § 523(a)(6). Because "willful" modifies the word "injury," the Supreme Court concluded that nondischargeability takes a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury.[79] The Supreme Court also noted that the language of § 523(a)(6) mirrors the definition of an intentional tort, which requires an actor to "intend 'the consequences of an act,' not simply 'the act itself.'"[80]

Malicious is the adjective for malice.[81] Black's Law Dictionary defines "malice" as "[t]he intent, without justification or excuse, to commit a wrongful act."[82] The focus of the "malicious" inquiry is on the debtor's actual knowledge or the reasonable foreseeability that his conduct will result in injury to the creditor, "not on abstract and perhaps moralistic notions of the 'wrongfulness' of

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78 523 U.S. 57 (1998).

79 *Id.* at 61.

80 *Id.* at 61-62 (citing *Restatement (Second) of Torts* § 8A, cmt. a (1964)).

81 *Black's Law Dictionary* 968 (7th ed. 1999).

82 *Id.*

the debtor's act."[83]

Injuries within the scope of § 523(a)(6) must be both willful and malicious.[84] The injury itself must be desired and in fact anticipated by the debtor in order for the debt to be excepted from discharge.[85] Injuries either negligently or recklessly inflicted do not come within the compass of § 523(a)(6).[86] Generally, an intentional breach of contract, without more, is not the type of injury addressed by § 523(a)(6).[87] Although conversion of property of another can serve as grounds for nondischargeability under § 523(a)(6),[88] not every conversion constitutes a willful and malicious injury within the meaning of § 523(a)(6). Intent to injure the creditor must be present.[89]

The bankruptcy court concluded "[Debtors'] actions were willful because the[y] intended to cause the consequences and/or they believed that the consequences were substantially certain to result," and "[t]he injury was

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[83] *C.I.T. Fin. Servs. v. Posta (In re Posta)*, 866 F.2d 364, 367 (10th Cir. 1989) (internal quotation marks omitted), *overruled in part on other grounds by Geiger*, 523 U.S. 57.

[84] *Panalis v. Moore (In re Moore)*, 357 F.3d 1125, 1129 (10th Cir. 2004).

[85] *Geiger*, 523 U.S. at 61-62. *See also In re Williams*, 337 F.3d 504, 509 (5th Cir. 2003) (test for determining whether debt is excepted from discharge as debt for debtor's "willful and malicious injury" is whether there exists either an objective substantial certainty of harm or a subjective motive to cause harm on the part of debtor).

[86] *Geiger*, 523 U.S. at 64.

[87] *See Dorr & Assocs. v. Pasek (In re Pasek)*, 129 B.R. 247, 252 (Bankr. D. Wyo. 1991), *aff'd*, 983 F.2d 1524 (10th Cir. 1993) (stating that "an intentional breach of contract, without more, is not sufficient to establish a willful and malicious injury for the purposes of § 523(a)(6).").

[88] *See Mitsubishi Motors Credit of Am., Inc. v. Longley (In re Longley)*, 235 B.R. 651, 657 (10th Cir. BAP 1999) (noting that "conversion can, under certain circumstances, give rise to a non-dischargeable debt pursuant to § 523(a)(6).").

[89] *See Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 332 (1934) (holding that "a willful and malicious injury does not follow as of course from every act of conversion, without reference to the circumstances.").

malicious because the Musgraves either intended the resulting injury or intentionally took action that was substantially certain to cause the injury to Hernandez."[90] The bankruptcy court's § 523(a)(6) conclusion is overly broad. The bankruptcy court found that Hernandez sustained actual damages for having to pay off the mechanic's liens, repair defective work on the Project, and complete the patio. Thus, Hernandez suffered three types of injuries. Each injury must be desired or anticipated by the debtors. The bankruptcy court, however, failed to analyze the injuries separately.[91]

Because Jeffrey Musgrave does not appeal the nondischargeability of the debts relative to the mechanics' liens, the cost to complete the patio, or the punitive damages assessed by the bankruptcy court, we need not address those awards. With respect to the Repair Cost, however, even if Jeffrey Musgrave was negligent in his supervision of the Project, Hernandez did not prove that he desired or anticipated that the subcontractors he hired to work on the Project would perform poorly. Likewise, there was no evidence that the subcontractors would likely perform poor work, or that the defects were substantially certain to occur. Further, there was no evidence that Jeffrey Musgrave intended to hire subcontractors who would defectively remodel Hernandez's restaurant. We conclude the bankruptcy court erred in holding that the Repair Cost was a nondischargeable debt under the willful and malicious injury exception of § 523(a)(6).[92]

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[90] *Judgment Opinion, Conclusions of Law* at 9, ¶ 6, *in* App. at 59.

[91] *See In re Williams*, 337 F.3d 504, 513 (5th Cir. 2003) (treating two different injuries differently under § 523(a)(6)); *Prewett v. Iberg (In re Iberg)*, 395 B.R. 83, 89 (Bankr. E.D. Ark. 2008) (applying two step examination: first, "what 'injury' the debt is 'for'" and second, "whether the debtor both [willfully and maliciously] caused that 'injury.'").

[92] *See Stevens v. Antonious (In re Antonious)*, 358 B.R. 172, 187-88 (Bankr. E.D. Pa. 2006); *Rezin v. Barr (In re Barr)*, 194 B.R. 1009, 1024 (Bankr. N.D. Ill.

(continued...)

In sum, we conclude the bankruptcy court erred in determining the Repair Cost a nondischargeable debt under §§ 523(a)(4) or (a)(6).[93]

D. Constructive Trust[94]

Debtors argue that the bankruptcy court erred in granting the relief of a constructive trust because (1) Plaintiff had never requested such relief, in pleadings or at trial, and thus they had no notice that such remedy could be awarded and (2) there was no evidence to support imposition of a constructive trust upon the Garfield House in favor of Hernandez. At oral argument, Debtors' counsel advised that the Musgraves have now obeyed the bankruptcy court's order to convey the Garfield House to Hernandez without requesting a stay or a supersedeas bond. Because the Musgraves have conveyed the Garfield House without a stay or supersedeas bond, this Court must first consider whether the constructive trust issue is moot.[95]

An appeal is moot if an event occurs while a case is pending on appeal that makes it impossible for the court to grant any effectual relief whatever to a prevailing party.[96] The sale or transfer of the object of the suit will generally

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[92] (...continued)
1996) (defective construction of house was not willful and malicious injury).

[93] *But see Fincher v. Holt (In re Holt)*, 173 B.R. 806, 817 (Bankr. M.D. Ga. 1994) (award for defective construction of log home held nondischargeable under § 523(a)(6) based on state court's determination that debtor's actions arose from tort rather than mere negligent construction or breach of contract).

[94] Given our reversal of the judgment against Maria Musgrave and the fact that she alone holds title to the Garfield House, the constructive trust issue appears moot. However, the bankruptcy court's constructive trust ruling referenced both Jeffrey and Maria Musgrave. We decline to decide whether that was proper and will concentrate on whether the record supports the bankruptcy court's conclusion.

[95] "Mootness is a threshold issue because the existence of a live case or controversy is a constitutional prerequisite to federal court jurisdiction." *McClendon v. City of Albuquerque*, 100 F.3d 863, 867 (10th Cir. 1996).

[96] *Church of Scientology of Cal. v. United States*, 506 U.S. 9, 12 (1992)
(continued...)

moot the appeal if the appellate court cannot grant effective relief.[97]

Because bankruptcy is basically a procedural forum designed to provide a collective proceeding for the sorting out of nonbankruptcy entitlements, we must consider the remedies available under the Bankruptcy Code and state law in any analysis of mootness.[98] In Colorado, the test of whether an appeal is moot is whether the party acted voluntarily or because of the actual or implied compulsion of judicial power.[99] A judgment debtor does not waive the right to have the judgment reviewed when he satisfies the judgment in obedience to a court order or under compulsion of an execution.[100] If a judgment is reversed, the judgment debtor is entitled to complete restoration of his property.[101] However, a party who satisfies or complies with a judgment assumes the risk of rendering his appeal moot if such action is done voluntarily.[102]

In *FCC Construction*, a general contractor brought an action to foreclose a mechanics' lien on the defendant's property. The defendant filed a motion for partial summary judgment, attacking the validity of the general contractor's lien on the ground that the lien statement was insufficient or defective. After a trial, the court concluded that the mechanic's lien was valid and entered judgment for

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[96] (...continued)
(citing cases).

[97] *Out of Line Sports, Inc. v. Rollerblade, Inc.*, 213 F.3d 500, 501 (10th Cir. 2000).

[98] *In re Osborn*, 24 F.3d 1199, 1203 (10th Cir. 1994). *See also Out of Line Sports*, 213 F.3d at 502 (applying Colorado law).

[99] *FCC Constr., Inc. v. Casino Creek Holdings, Ltd.*, 916 P.2d 1196, 1198 (Colo. Ct. App. 1996) (collecting cases).

[100] *Id.* at 1198 (citing *Reserve Life Ins. Co. v. Frankfather*, 225 P.2d 1035 (Colo. 1950)).

[101] *Id.*

[102] *Id.* at 1198.

the general contractor. The defendant made no request of the trial court to stay the pending foreclosure sale. The defendant appealed and challenged the validity of the lien, but made no request to stay the foreclosure sale pending resolution of the appeal. Approximately two months later, the general contractor was the successful bidder on the property at a foreclosure sale.

The defendant did not redeem the property and the redemption period expired. The general contractor sought dismissal of the appeal on mootness grounds in light of the foreclosure sale. The Colorado Court of Appeals concluded that the appeal did not fail for mootness because the defendant's actions were not inconsistent with its claim that the underlying order of sale was erroneous.[103] Rather, the defendant complied with the mandate of the trial court in allowing the foreclosure sale to proceed. The court stated that the fact that the defendant did not seek a stay of the foreclosure sale or redeem the property after the sale did not make its action voluntary.

In *Friedman v. Colorado National Bank of Denver*,[104] the trial court entered a decree of specific performance directing the defendant, a bank administering the estate of a deceased limited partner, to sell its limited partnership interest to the plaintiff, the surviving partner. After the trial court entered its decree, the plaintiff petitioned the court to hold the defendant in contempt for its failure to comply with that order or in the alternative, to post a supersedeas bond in the amount of eight million dollars ($8,000,000). In response, the defendant requested a stay to be secured by a five hundred dollar ($500) supersedeas bond. The trial court declined to hold the defendant in contempt, but ordered the parties to execute all necessary documents to carry out the court's decree and if the

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[103] *Id.*

[104] 825 P.2d 1033 (Colo. Ct. App. 1991), *aff'd in part, rev'd in part on other grounds*, 846 P.2d 159 (Colo. 1993) (en banc).

defendant posted a one hundred thousand dollar ($100,000) supersedeas bond, the clerk would retain possession of all documents pending appeal. The defendant claimed a financial inability to post the supersedeas bond amount and declined to post the bond. Thereafter, both parties complied with the court's specific performance degree.

The defendant in *Friedman* appealed, arguing the equitable remedy of specific performance was not available to the plaintiff because he breached his fiduciary duties to the deceased limited partner. The plaintiff argued that the defendant's failure to post a supersedeas bond rendered its appeal moot. The Colorado Court of Appeals disagreed and held that because the defendant did not agree to post a supersedeas bond, objected to the amount set by the court, and was faced with a charge of contempt for failing to abide by the court's order, the court could not conclude that the defendant's compliance was voluntary.[105]

In *Out of Line Sports*,[106] the Tenth Circuit held the appeal moot because there was a pattern indicating that the defendant consciously and voluntarily satisfied the district court's judgment. *Out of Line Sports* involved a judgment enforcing an attorney's lien on settlement funds. After the district court ordered the lien enforced, the parties filed a joint motion to release the funds, and the court disbursed the funds in accordance with the joint motion. The defendant then appealed the district court's order enforcing the lien, arguing the district court erred in refusing to admit evidence of the attorney's misconduct. The attorney filed a motion to dismiss the appeal for mootness.

The Tenth Circuit concluded that filing the joint motion represented a voluntary action in acknowledging satisfaction of the judgment given that the defendant did not file a motion to stay judgment, post a supersedeas bond, or

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[105] *Id.* at 1038.

[106] 213 F.3d 500, 502-03 (10th Cir. 2000).

attempt to explicitly reserve its right to appeal in the joint motion to release the funds. In addition, the parties had also agreed to release the funds in two previous motions, exhibiting a pattern that the defendant consciously and voluntarily satisfied the judgment. The Tenth Circuit acknowledged, however, that complying with a court's order without posting a supersedeas bond does not automatically moot an appeal.[107]

In this case, Debtors did not seek a stay or request a supersedeas bond. At oral argument, Debtors' counsel advised that Debtors did not seek a supersedeas bond because they were unable to post a bond, and complied with the court's order because they did not want to face contempt charges. Because there is no evidence of intent other than to comply with the bankruptcy court's order, we cannot conclude that Debtors' compliance was voluntary.[108]

The question is thus whether this Court can fashion some form of meaningful relief, notwithstanding Maria Musgrave's tender of title to Hernandez pursuant to the bankruptcy court order. If the bankruptcy court erred in imposing a constructive trust upon the Garfield house, then Hernandez wrongfully holds title to the Garfield House. Possible relief would be to void the conveyance to Hernandez or direct Hernandez to reconvey the Garfield House. We thus believe some form of relief can be fashioned. For that reason, we conclude Debtors' appeal of the constructive trust portion of the judgment is not moot.[109]

We now consider this issue on its merits. We review *de novo* the

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[107] *Id.* at 502 n.2 (citing *Friedman*, 825 P.2d at 1037-38).

[108] *See Stenback v. Front Range Fin. Corp.*, 764 P.2d 380, 383 (Colo. Ct. App. 1988) (a party's compliance with a court's decree or order, standing alone, will not be deemed a voluntary satisfaction of judgment sufficient to preclude the right to appeal).

[109] The situation could be different if, in the interim, Hernandez transferred the Garfield House to a bona fide third party purchaser. However, we are not aware of any transfer of the Garfield House by Hernandez.

bankruptcy court's imposition of a constructive trust.[110] Bankruptcy courts must look to state law to determine whether to impose a constructive trust.[111] Under Colorado law, to warrant imposition of a constructive trust upon the property of a debtor, a claimant must (1) show fraud or mistake in the debtor's acquisition of the property; and (2) be able to trace the wrongfully obtained funds to the property.[112]

The bankruptcy court made the following factual findings regarding the Garfield House: (1) the Musgraves purchased the house for $100,000 with an acquisition loan from Mountain Valley Bank, (2) they were insolvent at the time they acquired the property, and placed title solely in Maria Musgrave's name in an effort to shield the property from the claims of creditors, (3) they invested funds to remodel and improve the property, (4) they received a portion of the remodeling funds, approximately $35,000, from a separate bank loan, (5) on August 18, 2008, they obtained permanent financing for the property and jointly executed a promissory note and a deed of trust in favor of Mountain Valley Bank for $135,517.95, and (6) the remainder of the remodeling funds was derived from the proceeds of the Musgraves' theft from Hernandez, and invested in this property with the actual intent to hinder, delay, and defraud their creditors,

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[110] *United States Dept. of Energy v. Seneca Oil Co. (In re Seneca Oil Co.)*, 906 F.2d 1445, 1450 (10th Cir. 1990). *But see Adelphia Bus. Solutions, Inc. v. Abnos*, 482 F.3d 602, 607 (2d Cir. 2007) (bankruptcy court's decision whether to exercise its equitable authority is reviewed only for abuse of discretion); *Burkhart Grob Luft und Raumfahrt GmbH & Co. KG v. E-Systems, Inc.*, 257 F.3d 461, 469 (5th Cir. 2001) ("Because a constructive trust is an equitable remedy, the decision whether to impose it is entrusted to the discretion of the district court, and we review the district court's decision only for an abuse of discretion.").

[111] *Hill v. Kinzler (In re Foster)*, 275 F.3d 924, 926 (10th Cir. 2001).

[112] *Id.* (citing *In re Marriage of Allen*, 724 P.2d 651, 657 (Colo. 1986) (en banc) and *Seneca Oil*, 906 F.2d at 1449).

including Hernandez.[113] Based on these factual findings, the bankruptcy court concluded that "the acquisition of [the Garfield House was] the product of all this missing money, not all, but a good portion of it,"[114] and "the Musgraves' interest in the [Garfield House] was acquired under such circumstances that the holder of legal title may not in good conscience retain the beneficial interest."[115]

The bankruptcy court's factual findings, coupled with the evidence in the record, do not support its conclusion that Debtors acquired the Garfield House using the money misappropriated from Hernandez. The evidence established that Debtors purchased the Garfield House for $100,000 with an acquisition loan from Mountain Valley Bank. There was no evidence that Debtors made a down payment (using money from Hernandez or otherwise). If the purchase price was $100,000 and they obtained a loan in that amount, we cannot conclude that the home is the product of the missing money. The fact that Debtors had $147,000 in cash at the time of their bankruptcy is irrelevant to the acquisition of the Garfield House in light of the fact that there is no evidence those funds were used to acquire that property.

Likewise, the record does not support the bankruptcy court's conclusion

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113 *Judgment Opinion, Findings of Fact* at 7, ¶ 36, *in* App. at 57.

114 *Trial Tr.* at 138-139, *ll.* 16-25 and 1-5, *in* Supp. App. at 228-229:

> I would conclude . . . that the acquisition of [the Garfield House] in March of 2008, six months before the debtors filed for bankruptcy, and putting the home into Ms. Musgrave's name in order to try and shield to the greatest degree possible from creditor's claims, it is the product of all this missing money, not all, but a good portion of it. There is no other evidence before this Court to show the source of those funds. There is no other evidence to show that this debtor was not insolvent months before they filed in September, and indeed, it is one of the factual allegations admitted by the defendant in the stipulated facts. A reasonable person has to conclude[] that that home is the product, in whole or in great part, of the missing funds.

*Id.*

115 *Judgment Opinion, Conclusions of Law* at 9, ¶ 7, *in* App. at 59.

that Debtors used Hernandez's money to remodel the Garfield House. First, there was no evidence establishing how much money was used to remodel the Garfield House. Second, the evidence established that Debtors obtained a bank loan in the approximate amount of $35,000[116] to remodel the property, ultimately refinancing those loans into one for approximately $135,000. Without evidence of the total amount spent on remodeling, there can be no "remainder of the remodeling funds" that can be linked to Hernandez's money.[117] Moreover, even if we assumed that Debtors spent more than $35,000 to remodel the Garfield House, there is no evidence to trace Hernandez's money to the remodel.

Because the record does not support the bankruptcy court's conclusion, we hold the bankruptcy court erred in imposing a constructive trust upon the property.[118] As such, we vacate the bankruptcy court's order imposing the constructive trust and remand the cause for further proceedings consistent with this opinion and the current status of the property.[119]

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[116] *See* n.1, *supra*.

[117] Jeffrey Musgrave testified that the county had appraised the Garfield House at $179,000 and based on that figure, his realtor had listed the property for sale for $185,000. The bankruptcy court likely attributed the difference between the property's appraised value ($179,000) and the aggregate loans on the property ($135,000) to the remodel. The evidence, however, does not support such an assumption. Jeffrey Musgrave testified he and his brother-in-law provided free labor on the remodel, and the property was bought from a foreclosure; these two facts could explain the property's increased value.

[118] Because the evidence does not support the bankruptcy court's imposition of a constructive trust, we need not address Debtors' procedural argument that it was improper for the bankruptcy court to impose a constructive trust because such relief was not sought in the Complaint. Likewise, we need not address Debtors' argument that the constructive trust should be in a certain amount and only act as an equitable lien.

[119] For example, if no action relating to the property has been taken since Maria Musgrave tendered title to Hernandez, then directing Hernandez to transfer title would be appropriate. On the other hand, if the property has been sold and Hernandez has received proceeds from its sale, then those proceeds must be returned to the appropriate party. Other scenarios may apply, such as a foreclosure sale, which may render further action unnecessary.

E. Order Denying Motion for New Judgment

Debtors also appeal the bankruptcy court's Order Denying Motion for New Judgment. The bankruptcy court concluded that Debtors' motion offered no reason to alter its prior ruling under either Rules 59(e) or 60(b). Appellate courts generally review an order denying relief under Rules 59(e) or 60(b) for abuse of discretion.[120]

Given our review of the case and our reversal of the bankruptcy court's judgment against Maria Musgrave, its nondischargeability determination on the Repair Cost, and its imposition of a constructive trust, Debtors' appeal of the bankruptcy court's Order Denying Motion for New Judgment, is moot.

V. CONCLUSION

For the reasons stated above, we AFFIRM IN PART and REVERSE IN PART the bankruptcy court's judgment. We REVERSE the bankruptcy court's liability judgment against Maria Musgrave and VACATE the damage judgment against her. We REVERSE the portion of the bankruptcy court's judgment against Jeffrey Musgrave that held the Repair Cost debt nondischargeable. We REVERSE and VACATE the portion of the bankruptcy court's judgment imposing a constructive trust upon the Garfield Property in favor of Hernandez and REMAND the cause for further proceedings consistent with this opinion and the current status of the property. We DISMISS AS MOOT the Debtors' appeal of the Order Denying Motion for New Judgment. We AFFIRM the bankruptcy court's decision in all other respects.

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[120] *Phelps v. Hamilton*, 122 F.3d 1309, 1324 (10th Cir. 1997) (ruling on a Rule 59(e) motion reviewed for abuse of discretion); *Servants of the Paraclete v. Does*, 204 F.3d 1005, 1009 (10th Cir. 2000) (denial of a Rule 60(b) motion reviewed for abuse of discretion).