FILED
U.S. Bankruptcy Appellate Panel
of the Tenth Circuit
October 29, 2013
Blaine F. Bates
Clerk

NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY APPELLATE PANEL

OF THE TENTH CIRCUIT

IN RE GREG MATTHEW ROLLISON, Debtor.	BAP No. CO-13-028
HOLLY KNAUB and KELVIN KNAUB, Plaintiffs – Appellees, v. GREG MATTHEW ROLLISON, Defendant – Appellant.	Bankr. No. 09-27801 Adv. No. 10-01476 Chapter 7 OPINION*

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

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

THURMAN, Chief Judge.

We here consider plaintiffs' award of nondischargeable damages based on the debtor home builder's misrepresentation to them of his ability to build them a new home to replace a defective one they purchased previously. Because we hold that the benefit of the bargain rule was misapplied, we reverse and remand for consideration of the plaintiffs' damages consistent with this decision.

I. BACKGROUND

In the spring of 2003, Plaintiffs Holly and Kelvin Knaub (the "Knaubs")

* This unpublished opinion may be cited for its persuasive value, but is not precedential, except under the doctrines of law of the case, claim preclusion, and issue preclusion. 10th Cir. BAP L.R. 8018-6.

purchased a home built by a company then owned by the debtor, Greg Matthew Rollison ("Debtor"). Shortly after the Knaubs took possession of the house in May 2003, they noticed a number of construction problems, including cracks in the walls and windows that failed to work properly. Debtor's construction company, Gemm Homes, LLC ("Gemm"), which had issued a 2-year builder's warranty on the home, attempted to remedy the issues for some period of time. However, Gemm was unable to satisfactorily or permanently resolve the house's defects.

In 2006, an engineering firm investigated the house's many problems in an effort to determine their cause. Soil testing indicated that the house's foundation had been improperly laid on fill, rather than on natural soil, which led to excessive settling. Thereafter, several conversations and meetings took place between the Knaubs and Gemm, principally through Debtor, Robert Golba ("Golba"), and Jeremy Cameron ("Cameron"). Golba was Gemm's marketing manager at that time, and Cameron was the Knaubs' contact person at Gemm who had performed the warranty work on their home. Ultimately, the parties concluded that the settling of the Knaubs' house could not be fixed. As a result, in April or May of 2007, Debtor told the Knaubs that he would build them a new house. Debtor then directed Cameron to draw up blueprints for a new house, and Golba to find a new lot in the same subdivision that would work for the Knaubs. Based on Debtor's representations, the Knaubs believed that he had the financial ability to build them a new house, the anticipated cost of which was around $250,000.

Although both Debtor and Gemm were experiencing financial difficulties prior to his promise to the Knaubs, Debtor remained optimistic that at least some of the banks he worked with would continue their relationships with him. In February 2007, as Gemm's and Debtor's financial conditions worsened, Avalon Homes ("Avalon") was formed as a means to carry on Gemm's existing work.

Gemm's assets, office, and employees were all transferred to Avalon, and Gemm had ceased doing business by April 2007. At that point, the Knaubs, Debtor, and Golba all expected that Avalon and/or Debtor would make good on Gemm's contract with the Knaubs. By the end of the summer of 2007, however, it was clear that Debtor would be unable to obtain the necessary financing to purchase a rebuilding lot, and Golba informed the Knaubs that the rebuild was not going to happen.

In January 2008, the Knaubs filed suit in Colorado state court seeking damages from both Debtor and Golba, among others. Before the state court lawsuit could be tried, Golba and Debtor filed their respective petitions for Chapter 7 bankruptcy protection. The Knaubs then filed separate adversary proceedings against Golba and Debtor alleging false representation and actual fraud under 11 U.S.C. § 523(a)(2)(A),[1] as well as breach of fiduciary duty under § 523(a)(4), as grounds for nondischargeability of their claims against them.

By agreement of the parties, trial of the Knaubs' adversary proceeding was bifurcated, with the merits of their dischargeability claims tried first and, if necessary, trial would then be held on the amount of damages. After the liability phase of the Knaubs' case was tried against both Debtor and Golba, the bankruptcy court concluded that Debtor's debt to the Knaubs was nondischargeable under § 523(a)(2)(A), based on Debtor's "false representations as to his ability to perform on his agreement to build the Knaubs a replacement house, knowing such representations to be false, with the intent to deceive the Knaubs into believing such performance would take place" (the "Discharge Order").[2] The court denied the Knaubs' § 523(a)(4) claim against Debtor, and

---

[1] Unless otherwise noted, all further statutory references in this decision will be to the Bankruptcy Code, which is Title 11 of the United States Code.

[2] Discharge Order at 11, *in* Appellant's Appendix at 58.

denied all of their nondischargeability claims against Golba. The Knaubs did not appeal the bankruptcy court's judgment in favor of Golba, and that adversary proceeding was closed. Therefore, the Golba proceeding is not before us. Similarly, since Debtor did not appeal the Discharge Order, the merits of that decision are also not before this Court.

Two months prior to the scheduled trial on the issue of damages, Debtor filed a motion *in limine* to limit evidence of the Knaubs' damages to only those that occurred after the Debtor's promise to rebuild. That motion was denied on the ground that the Knaubs' damages were governed by the "benefit of the bargain rule," as set forth in *In re Mascio*.[3] Once the bankruptcy court ruled against his argument that the *Mascio* decision was distinguishable, Debtor stipulated that the difference between the defective house's value on the date of its purchase in May 2003 and the amount the Knaubs actually paid for it, believing it to be without defect, was equal to $162,000.[4] On March 28, 2013, the bankruptcy court determined that amount to be the Knaubs' nondischargeable damages resulting from Debtor's fraudulent statements to them (the "Damages Order"), and Debtor timely appealed that order on April 10, 2013.

II. APPELLATE JURISDICTION

This Court has jurisdiction to hear timely filed appeals from "final judgments, orders, and decrees" of bankruptcy courts within the Tenth Circuit, unless one of the parties elects to have the district court hear the appeal.[5] None of the parties elected to have this appeal heard by the United States District Court for the District of Colorado, and they have therefore consented to appellate

---

[3] *In re Mascio*, 454 B.R. 146 (D. Colo. 2011).

[4] The stipulation allowed the parties to avoid the additional expense of what was scheduled to be a three day trial on the damages issue.

[5] 28 U.S.C. § 158(a)(1), (b)(1), and (c)(1); Fed. R. Bankr. P. 8002; 10th Cir. BAP L.R. 8001-3.

review by this Court.

Debtor filed his notice of appeal from the Damages Order within 14 days of its entry, making it timely under Rule 8002(a).[6] An order that fully and finally resolves the issues in an adversary proceeding is a final order for purposes of appeal.[7] Since the notice of appeal was timely filed from a final, appealable order, this Court has jurisdiction over the appeal.[8]

III. ISSUE AND STANDARD OF REVIEW

We do not consider the merits of the bankruptcy court's Discharge Order, as that order was neither appealed nor argued, and Debtor accedes to the existence of a misrepresentation under § 523(a)(2)(A) that makes any damages the Knaubs suffered as a result of the misrepresentation nondischargeable in his bankruptcy. The only issue here is whether the bankruptcy court properly determined whether, and to what extent, the Knaubs were damaged by the misrepresentation. We review the bankruptcy court's application of damages law *de novo*, without deferring to the bankruptcy court's interpretation of the law.[9]

IV. DISCUSSION

Section 523(a)(2)(A), upon which Debtor's liability to the Knaubs is based, provides that a Chapter 7 discharge does not discharge any debt "for money, property, [or] services . . . to the extent obtained by – false pretenses, a false representation, or actual fraud[.]" Plaintiffs asserting nondischargeable misrepresentation liability under this provision must prove the following five

---

[6] Fed. R. Bankr. P. 8002(a). Unless otherwise noted, all further rule references in this decision will be to the Federal Rules of Bankruptcy Procedure.

[7] *In re Tri-Valley Distrib., Inc.*, 533 F.3d 1209, 1214 (10th Cir. 2008) (finality in bankruptcy is judged by the "particular adversary proceeding or discrete controversy" rather than the main case).

[8] 28 U.S.C. § 158.

[9] *Kelaidis v. Cmty. First Nat'l Bank (In re Kelaidis)*, 276 B.R. 266, 270 n.1 (10th Cir. BAP 2002).

elements by a preponderance of the evidence, in order to prevail: (1) the defendant made a material false representation, (2) with the intent to deceive the plaintiff, (3) the plaintiff relied on the false representation, (4) the plaintiff's reliance was justifiable, (5) and the defendant's false representation *caused the plaintiff to sustain a loss*.[10]

Because § 523(a)(2)(A) nondischargeability depends upon a debtor's underlying tort liability, we refer to the common law of torts when interpreting it.[11] One of the most fundamental concepts of tort law is "proximate cause," which requires a showing that the defendant's conduct led to the plaintiff's injury. Colorado applies the doctrine of proximate cause in tort claims, describing it as follows:

> In order to prevail on a tort claim, a plaintiff must prove by a preponderance of the evidence that a defendant committed an act which caused an injury to that plaintiff. Under Colorado law, an event is the proximate cause of another's [injury] if in the natural and probable sequence of things, it produced the claimed injury. It is an event without which the injury would not have occurred.[12]

Because § 523(a)(2)(A) liability is based in tort, that section includes proximate cause as an element as well:

> [T]he text of the Bankruptcy Code prohibits discharge of any debt "to the extent *obtained by*" fraud. 11 U.S.C. § 523(a)(2) (emphasis added). In interpreting this provision, the Court has recognized that, in order for a creditor to establish that a debt is not dischargeable, he must demonstrate that there is a causal nexus between the fraud and the debt.[13]

---

[10] *In re Oai Quang Luong*, 11-33875, 2013 WL 1385674, at *3 (Bankr. D. Colo. Apr. 4, 2013), (citing *Field v. Mans*, 516 U.S. 59 (1995) and *In re Riebesell*, 586 F.3d 782, 789 (10th Cir.2009)) (emphasis added). In this appeal, we are primarily concerned with element number 5.

[11] *Field v. Mans*, 516 U.S. at 60 (terms used in § 523(a)(2)(A) "imply elements that the common law has defined them to include").

[12] *Renaud v. Martin Marietta Corp.*, 749 F. Supp. 1545, 1551 (D. Colo. 1990), *aff'd*, 972 F.2d 304 (10th Cir. 1992) (internal quotation marks omitted).

[13] *Archer v. Warner*, 538 U.S. 314, 325 (2003) (citing *Cohen v. de la Cruz*, (continued...)

In the present case, the bankruptcy court determined that the Knaubs had established their justifiable reliance on Debtor's statement that he would build them a new house. The court did not, however, describe the factual basis of that reliance. In its traditional sense, reliance may be as simple as accepting that an employee will act according to the law and company policies.[14] But reliance under § 523(a)(2)(A) "is, in reality, nothing more nor less than the element of causation, since it is the creditor's reliance which provides the causal link between the debtor's false representation and the creditor's damage."[15] In turn, causation requires proof that "the damages sustained were in fact caused by the [debtor's] conduct constituting false pretenses."[16]

Although nondischargeability under § 523 is a matter of federal law, we determine "the existence and the amount of the underlying debt" under state law.[17] In the case before this Court, nondischargeable damages were awarded to the Knaubs in the amount of $162,000. This figure was intended to compensate the Knaubs for the injury caused them by Debtor's fraudulent statement that he would build them a new house to replace their defective one. The statement,

---

[13] (...continued)
523 U.S. 213, 218 (1998)). *See also Hernandez v. Musgrave (In re Musgrave)*, 2011 WL 312883, at *9 (10th Cir. BAP Feb. 2, 2011) ("*Cohen* requires the alleged fraud proximately cause the debt in order for it to be excepted from discharge."); 4-523 *Collier on Bankruptcy* ¶ 523.08[1][e] (Alan N. Resnick and Henry J. Sommer eds., 16th ed. 2013) (plaintiff's loss must be "the proximate consequence of the representation having been made").

[14] *Novartis Corp. v. Luppino (In re Luppino)*, 221 B.R. 693, 702 (Bankr. S.D. N.Y. 1998).

[15] *Id.* at 701.

[16] *Id.* at 702. *See also Arterburn v. Arterburn (In re Arterburn)*, 15 B.R. 189, 192 (Bankr. W.D. Okla. 1981) (a § 523(a)(2)(A) plaintiff who fails to "establish a casual relationship between the misrepresentation and the loss suffered" may not obtain a nondischargeable damage award).

[17] *Advanced Coatings, Int'l, Inc. v. Johnson (In re Johnson)*, 485 B.R. 642, 647 (Bankr. D. Colo. 2013).

made in 2007, was in the context of negotiating a solution to a contractual relationship that began when the Knaubs purchased a home from Debtor's company in 2003. Relying on *In re Mascio*,[18] the bankruptcy court determined that, in order to recover the "benefit of the bargain," the Knaubs were entitled to damages equal to the difference between the amount they paid for the house in 2003, believing it to be free of defects, and the actual value of the defective house they received, also in 2003.[19] The parties stipulated that $162,000 was the designated amount. The court in *Mascio*, however, applied the benefit of the bargain rule to the defendant's fraudulent statements about his company that induced the plaintiff to purchase a 49% ownership interest in it. Under the rule, the court held that evidence of defendant's statement of the company's value should be limited to the day that plaintiff purchased ownership interest in it, measured against the amount that was actually paid.[20]

The "benefit of the bargain" rule is typically only applied in tort cases involving fraud, rather than negligence. In negligence cases, damages are determined under the "out of pocket" rule.[21] Thus, damages awards for negligent misrepresentation are limited to those that put plaintiffs back into the position

---

[18] *In re Mascio*, 454 B.R. 146 (D. Colo. 2011).

[19] Dec. 28, 2012, Order denying Debtor's motion *in limine*, *in* Appellant's Appendix at 117-18.

[20] *In re Mascio*, 454 B.R. at 154.

[21] *See* Restatement (Second) of Torts § 549 (fraudulent misrepresentation damages) and § 552B (negligent misrepresentation damages) (1977). The out of pocket rule, in turn, is limited by the "economic loss rule," which precludes tort recovery for economic loss that results from breach of contract, and "restricts contracting parties to contractual remedies for those economic losses associated with the relationship, even when the breach might reasonably be viewed as a consequence of a contracting party's negligence." *Reed v. Carecentric Nat'l, LLC (In re Soporex, Inc.)*, 446 B.R. 750, 784 (Bankr. N.D. Tex. 2011). *See also Ctr. Operating Co., L.P. v. Base Holdings, LLC (In re Base Holdings, LLC)*, 487 B.R. 727, 759 (Bankr. N.D. Tex. 2012) (economic loss rule requires proof of "injury that is distinct, separate, and independent from the economic losses recoverable on a breach of contract claim").

they were in prior to entering into a transaction, whereas benefit of the bargain damages attempt to put plaintiffs into the position they would have been in if the defendant's statements inducing the parties' bargain were actually true.[22] The Colorado Supreme Court has addressed benefit of the bargain damages, as follows:

> A plaintiff *who has been fraudulently induced to enter a contract* may either rescind the contract [and recover contract damages] or affirm the contract and recover in tort for the damages caused by the fraudulent act. The plaintiff has the burden of proof and must establish by a preponderance of the evidence that he has in fact suffered damage and that the evidence introduced provides a reasonable basis for a computation of damages. Where the subject of a fraud is a conveyance of property, a plaintiff electing to affirm the contract is entitled to receive the benefit of the bargain, *i.e.*, the difference between the value of the property as represented and the actual value of the property as received. An essential element of such an award is actual damage. This damage cannot be based on mere speculation or conjecture, but once the fact of damage has been established with the requisite degree of certainty, uncertainty as to the amount of damages will not bar recovery.[23]

Thus, the "benefit of the bargain rule" does not apply absent proof of actual damage incurred as a result of the defendant's fraud. In the present case, the actual damage must have been caused by Debtor's fraudulent statement that he would build the Knaubs a new house. Simply stated, a promise made in 2007 could not have caused damages that were suffered by the Knaubs as a result of the sale to them of a defective house in 2003, as that damage was suffered long before the Debtor promised to rebuild.

In addition, Debtor's promise was not a "bargain" upon which damages for benefit of the bargain could be based. "Bargain" is defined in Black's Law Dictionary as "[an] agreement between parties for the exchange of promises or

---

[22] *See Alexander v. Certified Master Builder Corp.*, 43 F. Supp. 2d 1242, 1250-51 (D. Kan. 1999).

[23] *W. Cities Broad., Inc. v. Schueller*, 849 P.2d 44, 48 (Colo. 1993) (emphasis added) (citations and internal quotation marks omitted).

performances."[24] Thus, contract liability is based on mutual promises, while tort liability is not:

> The essential difference between a tort obligation and a contract obligation is the source of the parties' duties. Contract obligations arise from promises the parties have made to each other, while tort obligations generally arise from duties imposed by law to protect citizens from risk of physical harm or damage to their personal property. Contract law is intended to enforce the expectancy interests created by the parties' promises so that they can allocate risks and costs during their bargaining.[25]

Nonetheless, as already noted, where one party to a contract uses fraud to gain an advantage, the other party to that contract may affirm the contract and recover benefit of the bargain damages in tort.[26] But that principle necessarily only applies where fraud was the inducement to enter into a contract, or "bargain."[27] Thus, had Debtor fraudulently induced the Knaubs' purchase of their house in 2003 –a fact Knaubs' counsel admitted at oral argument did not apply here, they could have affirmed that purchase contract and recovered lost benefit of the bargain damages, in the amount of $162,000, in tort. Such damages would have been a debt owed to them by Debtor that "was obtained by" Debtor's fraud, and was therefore nondischargeable under § 523(a)(2)(A). However, the Knaubs did not allege fraud in the inducement of their 2003 purchase, nor did they enter into a new contract with the Debtor in 2007, since a contract requires mutual obligations. As such, there was no "bargain" reached in 2007 upon which to base the Knaubs' damages. Nor is there any authority for a court to grant benefit of the bargain damages based on an earlier contract that was not induced by fraud,

---

[24] *Black's Law Dictionary* 169 (9th ed. 2009).

[25] *BRW, Inc. v. Dufficy & Sons, Inc.*, 99 P.3d 66, 72 (Colo. 2004) (citations and internal quotation marks omitted).

[26] *See, e.g., W. Cities Broad., Inc.*, 849 P.2d at 48.

[27] *Id.* (plaintiff who has been *fraudulently induced* to enter contract may recover in tort for damages caused by the fraud).

which is essentially what the bankruptcy court did in this case.

Although benefit of the bargain damages were not appropriate in this case, the Knaubs may still be entitled to recover damages that were incurred as a result of Debtor's promise to rebuild.[28] Any such damages must, however, be the proximate result of the Debtor's promise in order to be recoverable. Therefore, the Knaubs may only recover damages that were incurred after the Debtor's promise was made, and that were caused by their reliance on Debtor performing that promise.

V. CONCLUSION

No evidence regarding the Knaubs' out of pocket losses, if any, was presented to the bankruptcy court, as that consideration was eliminated by the application of what we consider to be an incorrect measure of damages. Accordingly, we reverse the bankruptcy court's Damages Order and remand for further consideration of damages consistent with this opinion.

---

[28] Although the bankruptcy court determined that the Knaubs justifiably relied on Debtor's promise to rebuild in the Discharge Order, we view that determination to be in the nature of "traditional" reliance, in that they believed and expected Debtor to perform as promised. On the other hand, the issue of reliance as it relates to damages is whether they incurred losses based on their belief and expectation that Debtor would perform as stated. For example, if the Knaubs hired an architect to draw up plans for their new house, had an engineering firm perform soil tests on the new lot, or purchased materials for upgrades they may have wanted in the new house in reliance on the promise, such damages may be recoverable by them by virtue of the causal link between them and the Debtor's fraudulent promise.