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UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

HUBERT BECKWITH GRABAU,
Debtor.

Case No. 90-50053
Chapter 11

YESHWANT and VINAYA RANADIVE,
Plaintiffs,

MEMORANDUM OPINION

vs.

HUBERT BECKWITH GRABAU,
Defendant.

INTRODUCTION

At issue before this Court is the District Court's remand to determine whether the debtor, Grabau, acted with reckless indifference to the truth for the purpose of determining the dischargeability of Grabau's debt to the plaintiffs under 11 U.S.C. § 523(a)(2).¹

PROCEDURAL HISTORY

Plaintiffs, Yeshwant and Vinaya Ranadive, et al., commenced separate complaints to

¹ Hereinafter, all section references are to Title 11 of the United States Code (the "Bankruptcy Code") unless otherwise specified.

1 determine the dischargeability of their claims against two debtors, Hubert Beckwith Grabau and
2 Vincent Brown. The cases were consolidated for trial. After four days of trial, the Bankruptcy Court
3 took the matter under submission and issued a Memorandum Opinion on September 4, 1991. The
4 Bankruptcy Court concluded that Brown's debt to the plaintiffs in the amount of \$269,750 was not
5 dischargeable under § 523(a)(4) because, as the designated real estate broker of a corporate licensee
6 under Cal. Bus. & Prof. Code § 10159.2, he was a fiduciary to the plaintiffs. The Bankruptcy Court
7 further found that Brown had breached his fiduciary duty to the plaintiffs by failing to properly
8 supervise the company's activities to ensure complete compliance with the real estate laws.

9 The Bankruptcy Court also concluded that Grabau was not a fiduciary to the plaintiffs within
10 the meaning of § 523(a)(4). The Bankruptcy Court also found that Grabau's debt to the plaintiffs was
11 dischargeable because he did not obtain money from the plaintiffs through fraud, misrepresentation,
12 false pretenses, or actual fraud under § 523(a)(2).

13 The District Court reversed the Bankruptcy Court's determination that the debt from Brown
14 was nondischargeable. The issue is currently on appeal to the Ninth Circuit. The District Court
15 remanded for further findings by the Bankruptcy Court the determination whether defendant Grabau
16 acted with reckless indifference when he made representations to the plaintiffs.

18 **FACTS**

19 The plaintiffs are individual investors and pension and profit sharing plans of small businesses.
20 Allstate Investment Company ("Allstate") was in the loan brokerage business. In particular, it
21 matched investors with borrowers in the marketing and sales of second deeds of trust. The defendant
22 Grabau was a marketing vice-president and an investment advisor for Allstate. He was a licensed real
23 estate broker and salesperson, but he was acting in his capacity as a salesperson during the
24 transactions that are at issue.

25 Following an investigation and audit of Allstate's financial affairs, the California Department
26 of Real Estate concluded in December 1981 that Allstate was "out of trust" by at least \$350,000. In
27 order to generate cash for Allstate, Lee Danna, the president of Allstate, developed a program in
28 which investors could purchase a fractional interest in Allstate's inventory of "real estate owned"

1 property (the "REO property") on which Allstate had foreclosed on behalf of its investors upon
2 borrowers' defaults. The sales package prepared by Danna represented that Allstate was the owner of
3 the properties; the properties were suitable for rental; investors would receive a fractional interest in
4 the title to the properties; and investors would receive a substantial return on their investments.

5 During February and March 1982, several of the plaintiffs invested a total of \$92,000 in
6 Allstate's REO property program through Grabau. The remaining plaintiffs invested \$177,750
7 through other Allstate representatives. These transactions were documented by sales agreements
8 prepared by Allstate at Mr. Danna's instruction. Attached to the sales agreements were spreadsheets
9 that purported to set forth the current financial condition of the REO properties. Grabau did not
10 receive any commissions for the plaintiffs' investments in the REO program.

11 However, Allstate did not actually hold title to the REO properties. The investment funds
12 were commingled with other Allstate funds because of the absence of adequate operating procedures,
13 and the funds remain unaccounted for. The sales packages and sales agreements contained
14 misleading information regarding the REO investment program. The plaintiffs received neither an
15 interest in the REO properties, as represented, nor a return on their investment.

16 Grabau took no affirmative action to verify the accuracy of the representations made in
17 Allstate's documentation prior to accepting the plaintiffs' investments, but he accepted as true the
18 representations that Danna made to him. He was elected to Allstate's board in May 1982 and first
19 became aware of Allstate's adverse financial condition after May 1982. In August 1982, he learned
20 that Allstate did not hold title to the REO properties and did not have the funds to repay the
21 investors.

22 The plaintiffs argue that Grabau perpetuated the representations made in Allstate's
23 documentation without further investigation and failed to disclose to the plaintiffs immediately the
24 status of the REO investment program when he became aware of it in June or July 1992. Grabau
25 responds that his representations were based on reasonable reliance on Allstate's internal procedures
26 and that immediate disclosure would have been futile because Allstate was incapable of returning the
27 amounts invested.

28

1 claim for nondischargeability. In re Menna, 152 Bankr. 5, 6-7 (Bankr. D. Me. 1993)(real estate
2 company's indemnification claim against seller of business and real estate is dischargeable where
3 liability in underlying state court action was based on negligent misrepresentation); In re Ketaner, 154
4 Bankr. 459, 465 (Bankr. E.D. Va. 1992)(recklessness in making false representations regarding
5 ability to cover shortfall in use of Western Union commercial money transfer account must exceed
6 negligence and rise to the level of reckless disregard for the truth); In re Woodhull, 30 Bankr. 83, 86
7 (Bankr. E.D. Ark 1983)(seller's debt is dischargeable where there's no evidence that
8 misrepresentation by seller's agent regarding condition of septic tank was anything but negligent).

9
10 **D. Grabau's Reliance on Internal Procedures**

11 In making representations to the plaintiffs regarding the REO investment program, Grabau
12 relied heavily on Allstate's internal procedures. Danna advised him that the REO investments would
13 be handled pursuant to the same procedures that the company used for the processing of loans.
14 Danna also advised him that Allstate would deposit the investor funds in a trust account. Grabau had
15 no reason not to rely on internal procedures after having successfully relied on Allstate's professional
16 and support staff for five years. He also relied on Danna's representations to him that the properties
17 provided adequate security for the investments and were good investments and that Allstate had
18 engaged the services of a licensed building contractor to inspect the properties. He relied on in-house
19 counsel's expertise in preparing the sales agreements according to Danna's instruction.

20 Grabau had no actual knowledge of Allstate's financial condition or the status of the REO
21 investment program until sometime after the middle of 1992. He invested a total of \$81,500 in
22 personal funds into Allstate between April 1981 and May 1982 because he sincerely believed in
23 Allstate's potential for success. His brother, John Grabau, also invested \$150,000 in Allstate and
24 loaned \$800,000 to Allstate in May 1982. Like the defendant's agent in Schwartz v. Meyers, Grabau
25 continued to invest substantial amounts of personal funds in the company and encouraged family and
26 friends to do the same, which constitutes objective indicia of his belief in the statements he made to
27 the plaintiffs. See Schwartz v. Meyers, 130 Bankr. at 423-24. Grabau's reliance on Allstate's internal
28 procedures was not unreasonable under the circumstances and does not constitute reckless

1 indifference for the truth of his representations.
2

3 **CONCLUSION**

4 Exceptions to discharge are to be narrowly construed to give effect to the policy of the
5 debtor's fresh start. In re Riso, 978 F.2d 1151, 1153 (9th Cir. 1992). Grabau's conduct is at most
6 negligent and does not rise to the level of reckless indifference. As discussed above, negligent
7 conduct is insufficient to support a finding of nondischargeability.

8 Therefore, the plaintiffs' complaint to determine that the debtor's debt to them is
9 nondischargeable under § 523(a)(2) is denied.
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