

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF INDIANA
HAMMOND DIVISION

IN RE:)
)
GLEN ALVIN JONES and) CASE NO. 09-21155 JPK
JEANETTE MARIE JONES,) Chapter 7
Debtors.)

JAMES A. BELEI and)
CHRISTINE M. BELEI,)
Plaintiffs,)
v.) ADVERSARY NO. 09-2123
GLEN ALVIN JONES and)
JEANETTE MARIE JONES,)
Defendants.)

MEMORANDUM OF DECISION DETERMINING
DISCHARGEABILITY OF INDEBTEDNESS

This case arises from a complaint filed against the Debtors, Glen Alvin Jones and Jeanette Marie Jones (the “Joneses”), in which the Plaintiffs, James A. Belei and Christine M. Belei (the “Beleis”) request that a certain debt alleged to be owed to them by the Joneses be excepted from discharge pursuant to 11 U.S.C. § 523(a)(2)(A). This Court has jurisdiction over this adversary proceeding pursuant to 28 U.S.C. § 1334(b), 28 U.S.C. § 157(a), and N.D.Ind.L.R. 200.1(a)(2). This matter constitutes a “core” proceeding as defined by 28 U.S.C. § 157(b)(2)(I).

I. Statement of the Record

This adversary proceeding was initiated by a complaint filed on June 24, 2009. The Beleis allege that Glen and Jeanette Jones knowingly made certain material representations to them, which were false, concerning a house located at 122 South Connecticut Street in Hobart, Indiana (the “Property”), upon which representations they relied, thereby leading to their

purchase of the house and sustaining extensive damages due to water intrusion into the house's basement. The Beleis originally requested that the court deem the damages arising out of the foregoing transaction non-dischargeable pursuant to 11 U.S.C. § 523(a)(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny, and pursuant to 11 U.S.C. § 523(a)(2)(A) for, in this case, money obtained by false pretenses, a false representation or actual fraud. On July 23, 2009, the Joneses, by counsel, filed an answer to the complaint which denied all of the substantive allegations stated therein.

At a pre-trial conference on November 12, 2009, it was disclosed to the court that prior to the Joneses' filing their petition for relief under Chapter 7 of the United States Bankruptcy Code on March 31, 2009, an action between the parties had been fully tried in the Lake Circuit Court sitting in Lake County Indiana, under cause number 45C01-0210-PL-224. The state court's determination was suspended due to the bankruptcy filing. At a second preliminary pre-trial conference on January 13, 2010, the parties agreed that the factual record necessary for determining this adversary proceeding would be the trial record in the state court action. Additionally, the attorney for the Beleis agreed to withdraw from consideration the contention that the alleged debt was excepted from discharge pursuant to 11 U.S.C. § 523(a)(4). On January 28, 2010 the court entered an order which provided that the parties were to file the entire state court record in "hard copy" by presenting the record to the chambers of the court, and that the record as so filed would constitute the sole and entire evidentiary record for all purposes in this adversary proceeding, including the entry of final judgment. Additionally, as agreed by the parties, the order provided that no brief or legal memorandum would be filed by either party.

On March 12, 2010, the record of the state court trial was delivered to chambers. The following are the documents which constitute the entire record upon which this court will base its ruling as to the issue of whether the debt, if any, owed to the Beleis by the Joneses is

excepted from discharge pursuant to 11 U.S.C. § 523(a)(2)(A):

1. Transcript of the trial held in the Lake Circuit Court, Crown Point, Indiana (“Trial Transcript”).¹
2. Plaintiffs’ Exhibit #1: Purchase Agreement for the Property (“Purchase Agreement”).
3. Plaintiffs’ Exhibit #2: Seller’s Residential Real Estate Sales Disclosure.
4. Plaintiffs’ Exhibit #3: Settlement Statement dated November 9, 2000.
5. Plaintiffs’ Exhibit #4: Work estimate of Pozy’s Restoration, Inc. dated April 3, 2001.
6. Plaintiffs’ Exhibit #5: Time and Material Proposal of Largura, Inc. dated March 26, 2001.
7. Plaintiffs’ Exhibit #6: Work estimate of Everdry Waterproofing of Michiana dated March 7, 2001.
8. Plaintiffs’ Exhibit #7: Proposal from D&D Home Improvement.
9. Plaintiffs’ Exhibit #9: Verified Motion in Support of Fees and Costs Award.
10. Plaintiff’s Exhibit #10: A binder of pictures of the Plaintiff’s basement.
11. Plaintiffs’ Exhibit #11: Seller’s Residential Real Estate Sales Disclosure.
12. Defendants’ Exhibit A: A Rendering of the Property’s basement.
13. Defendants’ Exhibit B: Several pictures of the Property’s basement.

II. Legal Analysis

Under § 523(a)(2)(A) of the Bankruptcy Code, an individual debtor is not discharged from any debt –

(2) for money, property, services, or extension, renewal or refinancing of credit, to the extent obtained by –

(A) false pretenses, false representation, or actual fraud. . . .

In the case of *In re Hostetter*, 320 B.R. 674, 681 (Bankr. N.D. Ind. 2005), this court – in determining whether charges and cash advances on a credit card were excepted from

¹ The Trial Transcript discloses that the trial in the state court was held over three separate days: February 2, 2009, March 5, 2009 and March 13, 2009.

discharge – stated the elements necessary to establish a *prima facie* case under § 523(a)(2)(A):

Although the precise formulation and specification of the number of elements varies from decision to decision, in order to sustain a *prima facie* case of fraud under § 523(a)(2)(A), courts have traditionally required a creditor to establish that: (1) the debtor made a representation to the creditor; (2) at the time of the representation, the debtor knew it to be false or the representation was made with such reckless disregard for the truth as to constitute willful misrepresentation; (3) the debtor made the representation with the intent and purpose of deceiving the creditor; (4) the creditor relied on the representation resulting in a loss to the creditor; and (5) the creditor's reliance was justifiable; *In re Sheridan*, 57 F.3d 627, 635 (7th Cir. 1995); *Mayer v. Spanel Int'l, Ltd. (In re Mayer)*, 51 F.3d 670, 673, 676 (7th Cir.), *cert. denied*, 516 U.S. 1008 (1995); *In re Maurice*, 21 F.3d 767, 774 (7th Cir. 1994). The creditor must prove each element by a preponderance of the evidence. *Grogan v. Garner*, 498 U.S. 279, 291, 111 S.Ct. 654, 661 (1991); *In re Bero*, 110 F.3d 462, 465 (7th Cir. 1997). Finally, "exceptions to discharge are to be construed strictly against a creditor and in favor of the debtor." *In re Scarlata*, 979 F.2d 521, 524 (7th Cir. 1992), *reh. en banc den.* 1993; *In re Zarzynski*, 771 F.2d 304, 306 (7th Cir. 1985).

FN5. In *Field v. Mans*, 516 U.S. 59, 70, 116 S.Ct. 437, 446, 133 L.Ed.2d 351 (1995), the Supreme Court held that a creditor's reliance need only be justifiable, not reasonable.

This standard is the benchmark for determining whether a debt is excepted from discharge pursuant to § 523(a)(2)(A).

Practically speaking, whether the allegation is that the debtor acted under a false pretense, made a false representation or committed actual fraud – in order to prevail a creditor must prove that the debtor acted (in this case, made representations) with the intent and purpose of deceiving the creditor. In other words, the court must determine whether the debtor possessed the requisite scienter. This is not always an easy task. As recognized by the court in *Hostetter*:

As eloquently stated by the Honorable Kent Lindquist:

This finding of fact as to intention will obviously have to be

determined by circumstantial evidence in most cases as direct evidence of the Defendant's state of mind at the time of purchase is seldom expressly indicated. Although this is certainly a difficult task, it is no greater a task than any other cause of action that includes intent or state of mind as a necessary element. And the existence of fraud may be inferred if the totality of the circumstances present a picture of deceptive conduct by the Debtor which indicates he intended to deceive or cheat the creditor. *In re Fenninger*, 49 B.R. 307, 310, *supra*; *In re Taylor*, 49 B.R. 849, 851, *supra*. The Court may logically infer this intent not to pay from the relevant facts surrounding each particular case. See, *In re Kimzey*, 761 F.2d 421, 424, *supra*. And a person's intent, his state of mind, has been long recognized as capable of ascertainment and a statement of present intention is deemed a statement of a material existing fact sufficient to support a fraud action. *In re Pannell*, 27 B.R. 298, 302 (Bankr.E.D.N.Y.1983).

In re Hostetter, 320 B.R. at 685 (citing, *In re Faulk*, 69 B.R. 743, 755 (Bankr. N.D.Ind. 1986)).

In rendering a final decision under § 523(a)(2)(A), a court must consider objective evidence that is probative of the debtors' intent, but the ultimate inquiry is still to determine the debtor's subjective intent. *In re Hostetter*, 320 B.R. at 685. In the course of human events, even circumstantial evidence of intent may be the subject of conflicting testimony. In relation to determining the credibility of two witnesses in an action brought under § 523(a)(2)(A), the court in the case of *In re Fosco*, 289 B.R. 78, 87 (Bankr. N.D. Ill. 2002) stated the following:

It is well-settled that a court, when sitting without a jury, may take into account a witness' interest in the outcome of the case, his intentions, his seeming honesty ... *Welch v. Tennessee Valley Authority*, 108 F.2d 95, 101 (6th Cir. 1939).... It is by no means necessary for me to rely solely on the words used by a witness when making up my mind about the truth of the matter the witness testifies to. *Id.* at 269. Within the bounds of reason, I am at liberty to reject the testimony of a witness that does not produce conviction in my mind about its truthfulness. *Joseph v. Donover Co.*, 261 F.2d 812, 824 (9th Cir. 1958). On the other hand, of course, I am not at liberty to arbitrarily reject uncontroverted evidence. *Id.*

Cutting to the core of the determination of exception from discharge, the court determines the following as to certain of the five elements required under *In re Hostetter*:

1. The record establishes that the Joneses made certain representations to the Beleis as to the subject property's not being affected by problems associated with the intrusion of water into the house, thus satisfying the first element of *Hostetter*.

2. The record establishes that the Beleis relied upon representations as to the lack of water problems with respect to their purchase of the house, and that freedom from water problems was material to their decision to purchase the house, thus in part satisfying criteria #4 in *In re Hostetter*.²

3. The Beleis' reliance on the Jones' representations as to "water intrusion problems" with respect to the house was justifiable³, thus satisfying the fifth element of *Hostetter*.

4. The crux of this case is whether representations made by the Joneses as to the property's not being subject to "water intrusion problems" were known to be false, or were made with such reckless disregard for the truth as to constitute willful misrepresentation, at the time that they were made by the Beleis, and whether the representations were made by the Joneses with the intent and purpose of deceiving the Beleis, i.e., the second and third elements of the *Hostetter* standard.

The parties have stipulated to the court's determination of this case on the record established in a prior trial. The court did not have the opportunity to observe the demeanor of witnesses, and thus certain of the findings made by the court are made on a "cold" record. Nevertheless, because this case has been submitted on a stipulated record, the court is free to draw inferences from the record itself, and to determine the credibility of statements made

² Whether or not reliance on representations "resulted in a loss to the Beleis" will be discussed subsequently.

³ This reliance was affirmed by the Beleis' inspector, who found that there were no water intrusion problems.

based upon the record before it.

Cutting to the quick, the factual issue before the court is whether the Joneses knew at the time that they made representations concerning “water intrusion problems” with respect to the property that the property had experienced, and at the time the representations were made continued to experience, “water intrusion problems” about which they lied, or about which they should have reasonably known they were making false statements, thus intending to induce the Beleis to purchase the property by means of deception.

The Beleis complain about essentially three distinct issues with water intrusion into the basement of the house:

1. Occasional accumulation of water on the floor in certain parts of the basement;
2. The existence of mold in portions of the basement as a result of water intrusion into the basement; and
3. Condensation in the “canning room”.

Let’s first generally address the intrusion of water into the basement, as that intrusion was known or should have been known by the Joneses. The Beleis, particularly Mrs. Belei, inspected the basement prior to closing, and she observed no water intrusion problems in the basement. The Beleis engaged the services of an independent inspector, who noted no problems with water intrusion into the basement in his inspection.⁴ Upon examination by the judge in the state court proceeding, Mrs. Belei stated that she noticed no musty smell in the

⁴ The inspector apparently noted an issue concerning a “bowed wall”. According to the testimony of Mrs. Belei, the inspector stated essentially that in his opinion the Joneses had explained that this manifestation had created no “water intrusion problem”, and he therefore did not deem this item to be of necessary concern. It is totally remarkable to the court that neither of the parties in the state court proceeding sought to submit the inspector’s report into evidence, or call the inspector as a witness. That being the case, the evidence before the court is that the property was fully inspected by an independent inspector on behalf of the Beleis prior to closing; that the inspector produced a report which noted no problems with respect to “water intrusion” into the basement; and that this inspection/report was done based upon personal observation of the inspector of the basement.

basement when she inspected it personally. Mrs. Belei testified that the basement walls, including the “canning room”, gave the appearance of having been freshly painted, but that she didn’t know or couldn’t tell whether the walls had been freshly painted. The point of this is that Mrs. Belei observed no indication of intrusion of water into the basement, such as “pops” in the paint, crumbling of the cinder block walls, or musty odors. Mrs. Belei also testified that the carpeting in the basement “looked brand new”. This testimony again evidences a lack of observable damage resulting from water intrusion into the basement. The testimony of the Joneses, which the court accepts as true, is that the walls in the basement were painted in 1995, long before Mrs. Beleis’ inspection of the basement, and that the carpeting was placed in the basement at a time not immediately before Mrs. Beleis’ inspection.

The court thus determines that at the time the property was inspected by the Beleis and their independent inspector prior to closing, there was no evidence of an issue regarding “water intrusion problems” in the basement with respect to the floors or walls of the basement.

Let’s talk about yellow streaks on the walls. Mrs. Belei testified that after she and her husband moved into the home, property of the Joneses had been removed from portions of the basement, and she then observed yellow streaks running up and down parts of the walls in the basement, including the “canning room”. That is as far as the testimony goes – someone observed “yellow streaks” on the walls. There is no connection in this record between “yellow streaks on the walls” and the intrusion of water. Colored streaks on basement walls can arise from the number of reasons, one of which is the intrusion of water. But there are many other reasons why “yellow streaks” would be on walls. All this record states is that “yellow streaks” were observed on basement walls. The court will not draw an inference, absent any other evidence in this record, as to the cause of the “yellow streaks”, including that the yellow streaks evidenced an intrusion of water into the basement. It was for the plaintiffs to establish that the “yellow streaks” indicated the intrusion of water, which they failed to do.

The evidence is clear that the Beleis experienced a water intrusion problem in the early months of 2001, following the closing on November 9, 2000. The fact that water problems occurred after the closing is not in and of itself material to the issues of fraudulent misrepresentation asserted by the Beleis. Both Mr. and Mrs. Jones stated that they had experienced no significant water intrusion problems into the basement throughout their ownership of the house. Both Mr. and Mrs. Jones stated that extenders had always been in place on the down spouts around the perimeter of the house throughout their occupancy of the property⁵. The court finds that the evidence establishes that after they took possession of the property, the Beleis definitely removed down spout extenders from certain of the down spouts around the perimeter of the property; whether they removed the down spouts themselves from certain of the gutter “drains” extending vertically from the gutters down the side of the house is not established either way by this record.⁶ The court also finds that during the very early winter of 2001, the Beleis – apparently for the benefit of their children – built a snow fort against the side of the house. The court concludes that the removal of down spout extenders caused water from snow melt to be allowed to accumulate against the foundation of the home, a foundation comprised of concrete block and not of poured cement, and thus more pervious to water intrusion. The court finds that the building of a snow fort – essentially a large accumulation of snow – against the foundation further allowed water to accumulate against the foundation of the house. Based upon the foregoing, and the court’s previous finding that there were no objective indications of “water intrusion problems” at the time of closing or before closing, the court finds

⁵ While photographs of the house during the Joneses’ occupancy evidence relatively short extenders, these extenders were long enough to cause water from the gutters to be directed away from the foundation of the house.

⁶ Mrs. Belei testified that while the downspouts were always left on the vertical gutter drains, the extensions may well have been removed. The removal of the extenders is critical; removal of downspouts would not have greatly increased the consequences that removal of the extenders caused.

that the water intrusion problems experienced by the Beleis in their early occupancy of the house are in significant part explained by their allowing an accumulation of snow melt water to exist immediately next to a concrete block foundation – something which the court finds the Joneses never allowed to happen.

Then there's the "french drain" matter. The house apparently had some form of internal drainage channeling system in the interior of the basement, along the basement walls. The Joneses testified that they had never experienced a problem with drainage in the basement in relation to this system, and indeed the inspection by the Beleis' independent inspector and by Mrs. Belei did not note any. There is conflicting testimony by two contractors called by the Beleis as witnesses as to whether or not the house actually had a "french drain". For the purposes of this decision, it doesn't matter whether it did or not, but let's give witness Steven Pozy his due and assume that the house had an interior french drain. Mr. Pozy was unable to state whether or not problems with the french drain would have existed in an observable state prior to closing. So again, there is no evidence in this record that any problem with the so-called "french drain" was observable by, or known to, the Joneses at the time the sale transaction was negotiated and representations concerning "water intrusion problems" were made.

Putting the foregoing together, Mrs. Belei observed no demonstrable problems as to water intrusion in the basement prior to closing, despite having inspected the basement several times prior to that time. The independent inspector employed by the Beleis did not note any "water intrusion problems". The testimony of Steven Pozy (more of this later) establishes that in April of 2001 – five months after closing – he observed water intrusion problems in the basement, which has no material relevance as to whether or not those problems were observable to the Joneses at the time they marketed the home and made representations to the Beleis. There is no evidence in this record of paint popping on the walls, discoloration of

carpeting, of wetness, of mold or mildew, of a “smell” indicating mold or mildew – in the basement at any time prior to closing, nor at the time any representation was alleged to have been made by the Joneses to the Beleis as to “water intrusion problems”.

The court determines that the Joneses did not know, and should not reasonably have known, of any water intrusion problems into the basement of the house at the time representations were made by them to the Beleis as to the lack of those problems.

Let’s next talk about mold. The record clearly establishes that at some point after they took occupancy of the property, the Beleis experienced mold in the basement. The testimony of Steven Pozy establishes that he observed mold in the basement in April of 2001. There is no evidence in this record that any mold was observable at the time representations were made by the Joneses to the Beleis as to the lack of water problems in the basement. The testimony of Steven Pozy establishes that “white mold” can grow in 90 days, and that it is also possible for “black mold” to grow in 90 days.⁷ Mr. Pozy’s testimony is essentially that mold could have been growing in the interior of the concrete block without any external manifestation on the walls of the basement for an extended period of time, and that even if that were not the case, the mold experienced by the Beleis could have grown rapidly over a period of 90 days and then intruded onto the interior walls of the basement. Again, at the time of inspections prior to closing, there is no evidence that there was any observable mold on the walls in the basement. Mr. Pozy’s testimony is in the court’s view essentially that mold grew in the interior spaces of the concrete block foundation and then “grew out” externally onto the interior walls of the basement. Mr. Pozy’s testimony as to the “incubation” period for mold is consistent with there being no

⁷ Steven Pozy testified that essentially the difference between “white mold” and “black mold” is that “white mold” gets dirty and turns black. The court has no basis to judge the accuracy of this testimony, but suffice it to say that the court is skeptical of this explanation for the difference between “white mold” and “black mold”, based in part upon Mr. Pozy’s testimony that the difference between molds depends upon the medium upon which they grow.

observable problem with mold in the basement until after the closing. There is nothing in this record that establishes that the Joneses knew or should have known that there was a “mold problem” in the basement generally at the time representations were made by them to the Beleis as to the lack of problems associated with water intrusion into the basement.⁸

We now come to condensation in the canning room. The evidence establishes that the “canning room” is essentially an outcropping from the perimeter of the basement built under the front porch slab of the house, and that the ceiling of the canning room is essentially the uninsulated base of the front porch concrete stoop. Mrs. Jones’ testimony in relation to knowledge of any condensation or other issues in the canning room was vacillatory; the court finds, based upon that testimony and the entire record, that there was in fact condensation in the canning room that was known to the Joneses. However, this is not surprising, in that the ceiling of the canning room is a large piece of concrete exposed to the elements outside the house, and is therefore subject to rather significant temperature variances between the temperature of the stoop and the temperature of the interior of the basement to which it immediately adjoins. Of course there was condensation in the canning room. The court finds that Mrs. Jones admitted as much to Mrs. Belei, but in doing so said that it posed no problem with respect to water intrusion into the house. This was actually a true statement – the condensation in the canning room was not a “water intrusion problem”, but rather is entirely explained by the differential in temperature between the ceiling of the canning room and the interior space to which it adjoins, which – when there are significant differences between the exterior temperature of the house and the interior temperature of the basement – causes condensation. The evidence establishes to the court’s satisfaction that Mrs. Jones disclosed the condensation, and stated that it was not a significant problem. The court finds that the

⁸ Mr. Pozy’s bald statement that the Joneses must have known about water problems he observed months after closing is not supported by his own testimony.

statements made by Mrs. Jones were true: the condensation was droplets of water on the ceiling of the canning room, not a significant problem in the context of “water in the basement”, and a very normal occurrence in almost any basement in any house in certain circumstances. Condensation in a subterranean basement in any house is always an issue if dehumidifiers and temperature control measures are not put in place, particularly in a circumstance of that of the canning room. The “condensation” was not a “water intrusion” issue, but rather was a “condensation” issue, perhaps rather easily remedied by a vapor barrier and insulation in the ceiling of the canning room to “seal off” the bare surface of the concrete pad from the interior of the house. Particularly lacking from the record is any concrete evidence of how the Beleis dealt with the condensation in the canning room, e.g., the specifics of any effort made to “seal” the ceiling, or to attempt to control the humidity or temperature in the basement, and that then despite such efforts, the condensation persisted as a continuous, unstoppable problem. The court finds that the Mrs. Jones addressed the condensation issue with Mrs. Belei and stated that it was not “a problem”, and that in terms of a material misrepresentation that relates to water intrusion problems of the nature of those which could have reasonably concerned the Beleis, the statements made by Mrs. Jones were true. We’re talking about a basement in an older home with a concrete block foundation, and a circumstance concerning condensation which is customarily experienced by nearly every homeowner whose house has a subterranean basement, no matter what its construction.

Based upon the record, the court finds that Mrs. Jones acknowledged that there was a condensation “issue” in the canning room, but that her statement that the “problem” had essentially been taken care of was accurate enough for the purposes of avoiding an intentionally false statement. The court also finds that condensation in the “canning room” in the very narrow and limited extent that it occurred to the knowledge of the Joneses was not a material issue, and could not reasonably have been a material issue, for the Beleis in their

decision to buy the home, in that any basement in any house – whether the foundation is concrete block or poured concrete – will occasionally experience condensation problems based upon the variance between external temperature and internal temperature, and the differential between internal and external moisture levels in the air.

Putting all of the foregoing together, the court finds that this case presents a circumstance in which there appears to have been a water intrusion problem waiting to happen – the accumulation of water in a porous concrete block foundation that had not yet manifested itself as a problem. There is no evidence that there was any manifestation of a water problem at the time representations were made by the Joneses as to the lack of one, and there is no concrete evidence that the Joneses knew or should have known of the immediacy of the potential problem created by what may have been the failure of the drainage system in the house. Moreover, the evidence is consistent with the intrusion of water into the basement in early 2001 being in significant part the result of the Beleis' removal of down spout extenders (even if not in fact the down spouts themselves) and the construction of a snow fort immediately adjoining the foundation of the house – which resulted in the intrusion of water in a manner which the Joneses' treatment of the property could not have disclosed to them was, or would be, a problem.

Based upon the foregoing, the court finds that the representations of Glen A. Jones and Jeannette Jones concerning water intrusion, mold, and condensation made to James Belei and Christine Belei were not made with knowledge of the falsity of the representations or with reckless disregard for the truth as to the representations, and were not made with any intent or purpose to deceive the Beleis.

The court determines that any debt alleged by the Beleis with respect to the Joneses is not excepted from discharge pursuant to 11 U.S.C. § 523(a)(2)(A).

IT IS ORDERED, ADJUDGED AND DECREED that the relief requested by James Belei

and Christine Belei that a debt alleged to be owed to them by Glen A. Jones and Jeanette Jones be excepted from discharge pursuant to 11 U.S.C. § 523(a)(2)(A) – is DENIED.

Dated at Hammond, Indiana on December 1, 2010.

/s/ J. Philip Klingeberger
J. Philip Klingeberger, Judge
United States Bankruptcy Court

Distribution:
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