Order Filed on June 25, 2018 by
Clerk U.S. Bankruptcy Court
District of New Jersey

**UNITED STATES BANKRUPTCY COURT**
**DISTRICT OF NEW JERSEY**

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| In Re:<br>**BERNABE CABRERA,**<br>Debtor. | Case No.: 17-16556-JKS<br>Adv. Pro. No.: 17-01721-JKS<br>Judge: Hon. John K. Sherwood |
| **BERNABE CABRERA,**<br>Plaintiff,<br>vs.<br>**ABEL HERNANDEZ,**<br>Defendant. | |

**DECISION AND ORDER**
**DENYING PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT**

The relief set forth on the following pages, numbered two (2) through twenty-six (26), is hereby **ORDERED**.

**DATED: June 25, 2018**

Honorable John K. Sherwood
United States Bankruptcy Court

**APPEARANCES:**

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## BACKGROUND

Bernabe Cabrera (the "Plaintiff") and Abel Hernandez (the "Debtor") were partners in a restaurant located at 757-771 Farragut Place, West New York, New Jersey named Marinero Grill ("MG"). The Debtor was solely responsible for managing MG. The partnership turned sour and both parties filed complaints against each other in the New Jersey Superior Court, Chancery Division, Hudson County. The Plaintiff submitted evidence to the state court that the Debtor was mismanaging the restaurant and misappropriating MG's funds. This prompted the state court to appoint Joseph Petrucelli, C.P.A. ("Petrucelli") as a monitor to oversee MG's operations. The parties subsequently entered into a consent order that dismissed the consolidated actions in favor of binding arbitration before retired Honorable Thomas P. Olivieri (the "Arbitrator").[1] Petrucelli remained in his role as the monitor and submitted reports to the Arbitrator that detailed the Debtor's shoddy accounting practices, which left $849,248 unaccounted for and a potential tax liability between $300,000-$350,000.[2]

The Arbitrator ultimately found the Debtor liable and entered an interim decision on December 29, 2015[3] that detailed the basis for his findings of liability and a final decision on November 18, 2016[4] that awarded monetary damages to the Plaintiff. On March 8, 2017, the state court confirmed the Arbitrator's award[5] and entered judgment for the Plaintiff in the amount of

[1] Plaintiff's Mot. for Summ. J., Ex. M, ECF No. 9.
[2] Plaintiff's Mot. for Summ. J., Ex. N, at 38-39, ECF No. 9.
[3] Plaintiff's Mot. for Summ. J., Ex. N, ECF No. 9.
[4] Plaintiff's Mot. for Summ. J., Ex. O, ECF No. 9.
[5] Plaintiff's Mot. for Summ. J., Ex. P, ECF No. 9.

$880,464.01.[6] Soon after, on March 31, 2017, the Debtor filed for protection under Chapter 11 of the United States Bankruptcy Code.[7] On November 22, 2017, the case was converted to Chapter 7[8] and Benjamin A. Stanziale, Jr. was appointed as Trustee.[9]

On November 16, 2017, the Plaintiff filed an adversary complaint against the Debtor seeking a declaration that the $880,464.01 judgment is non-dischargeable under 11 U.S.C. §§ 523(a)(4) and 523(a)(6) due to the Arbitrator's findings related to the Debtor's shoddy record keeping and misappropriation of funds.[10] Plaintiff also sought denial of the Debtor's discharge under §§ 727(a)(3) and 727(a)(5). The Debtor filed an answer on February 28, 2017 in which he denied any intentional wrongdoing such as fraud, defalcation, or malicious and willful injury. He also denied that his bankruptcy petition was inaccurate or incomplete.[11]

On March 13, 2018, the Plaintiff filed a motion for summary judgment seeking to deny the Debtor a bankruptcy discharge of any debts. Plaintiff also sought a declaration that his claim against the Debtor was non-dischargeable.[12] The Debtor filed opposition on April 10, 2018[13] and the Plaintiff responded on April 20, 2018.[14] On May 1, 2018, the Court held a hearing and permitted supplemental pleadings, which the parties filed on May 11, 2018.[15] A final hearing was

[6] Plaintiff's Mot. for Summ. J., Ex. Q, ECF No. 9.
[7] Chapter 11 Voluntary Pet., *In re Abel Hernandez*, No. 17-16556 (JKS), ECF No. 1.
[8] Order Granting Motion to Convert Case to Chapter 7, *In re Abel Hernandez*, No. 17-16556 (JKS), ECF No. 79.
[9] Appointment of Trustee, *In re Abel Hernandez*, No. 17-16556 (JKS), ECF No. 83.
[10] Adversary Compl., ECF No. 1.
[11] Answer to Compl., ECF No. 3.
[12] Plaintiff's Mot. for Summ. J., ECF No. 9.
[13] Debtor's Opposition to Plaintiff's Mot. for Summ. J., ECF No. 11.
[14] Plaintiff's Response to Debtor's Opposition to Plaintiff's Mot. for Summ. J., ECF No. 13.
[15] Plaintiff's Supplemental Submission in further support of Plaintiff's Mot. for Summ. J., ECF No. 14; Debtor's Supplemental Opposition to Plaintiff's Mot. for Summ. J., ECF No. 15.

held on May 15, 2018 and the Court reserved decision.

The issue before this Court is whether the Arbitrator's findings of shoddy accounting practices, misappropriation of funds and a logical inference that at least some of the unaccounted $849,248 was for the Debtor's personal use warrants summary judgment under 11 U.S.C. §§ 523(a)(4), 523(a)(6), 727(a)(3) or 727(a)(5).

## JURISDICTION

The Court has jurisdiction over this proceeding pursuant to 28 U.S.C. §§ 1334(b), 157(a) and the Standing Order of Reference from the United States District Court for the District of New Jersey dated July 23, 1984, as amended September 18, 2012. This matter is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A), (I) and (J). Venue is proper under 28 U.S.C. §§ 1408 and 1409(a).

## DISCUSSION

### A. COLLATERAL ESTOPPEL

The Court must first determine whether to apply the doctrine of collateral estoppel based on the Arbitrator's decisions and the resulting state court judgment that were rendered after lengthy litigation.

> "Collateral estoppel, also known as issue preclusion, prevents re-litigation of a particular fact or legal issue that was litigated in an earlier action. In order for the doctrine to apply, (1) the issue decided in the prior adjudication must be identical to the one presented in the later action, (2) there must be a final judgment on the merits and (3) the party against whom the doctrine is asserted must have been a party or in privity with a party to the prior

> adjudication and have had a full and fair opportunity to litigate the issue in question in the prior action."[16]

The second and third elements of collateral estoppel are easily satisfied as there was a final judgment and the Debtor fully participated in the state court proceedings. As for the first element, the Third Circuit has recognized that "[a]lthough state courts may not determine dischargeability of a debt, the principles of collateral estoppel may be applied to discharge exception proceedings to prevent relitigation of relevant issues that have previously been adjudicated by state courts."[17] Furthermore, determinations made by an arbitrator are entitled to preclusive effect if the proceedings entailed the essential elements of adjudication.[18] Thus, although dischargeability was not an issue for the Arbitrator in the state court matter, this Court may rely on the Arbitrator's findings and any preclusive effect they may have on the issues encompassed under 11 U.S.C. §§ 523(a)(4), 523(a)(6), 727(a)(3) and 727(a)(5).

**B. THE ARBITRATOR'S DECISIONS**

The Arbitrator made the following determinations in his forty-two-page interim decision that are relevant to the issue of dischargeability:

- "Hernandez managed the day-to-day operations of MG. Hernandez testified that he had previously owned restaurants."[19]
- "Hernandez has managed MG since its opening in the beginning of 2010.

[16] *Seborowski v. Pittsburgh Press Co.*, 188 F.3d 163, 169 (3d Cir. 1999) (citing *Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322, 326, (1979); *Dici v. Commonwealth of Pennsylvania*, 91 F.3d 542, 548 (3d Cir. 1996)).
[17] *Aiello v. Aiello (In re Aiello)*, 660 F. App'x 179, 182 (3d Cir. 2016) (citing *Grogan v. Garner*, 498 U.S. 279, 284 n.11 (1991)).
[18] *Konieczny v. Micciche*, 305 N.J. Super. 375, 384-85 (App. Div. 1997).
[19] Plaintiff's Mot. for Summ. J., Ex. N, at 6, ECF No. 9.

Hernandez admitted that from 2010 to 2013, he underreported $849,248 in sales to the State of New Jersey. Hernandez also paid employees in cash and failed to pay payroll taxes. This amount of unfounded tax liability totals $383,508. Estimated penalties and interest equal $139,000."[20]

- "Hernandez also admitted to keeping two (2) sets of books. One of those books was a cash ledger (the "Ledger"). Those receipts were not reflected on MG's tax returns."[21]
- "Petrucelli visited MG on August 14, 2013 and looked for normal accounting records, such as an electronic ledger, tax returns and payroll records to determine if sales tax, payroll taxes and corporate taxes were being paid. When Petrucelli reviewed the tax return, it did not correlate with documents he had been given, Petrucelli testified that he took bank records and attempted to establish the total to gross receipts and found large disparities. According to Petrucelli, MG's bookkeeper, Nuria Gonzalez, had everything written out but the handwritten document did not reconcile with the electronic QuickBooks. … Petrucelli found that older records had been purged requiring him to retrieve bank records and create financial records. Petrucelli was able to capture some data to roll forward and attain a comfort level that certain numbers should be reported and that proper accounting procedures should be implemented."[22]

[20] *Id*. at 6-7.
[21] *Id*. at 7.
[22] *Id*. at 9.

- "Petrucelli found that in 2011, MG reported $631,448 in sales to New Jersey but the actual sales were $919,096. In 2012, MG declared $645,365 in sales to New Jersey. Petrucelli found $1,016,128 in actual sales. For the first and second quarter of 2013, MG declared $299,998 in sales. For that same time period, Petrucelli found actual sales of $490,736. The total difference in unreported sales to New Jersey for these time periods is $849,248."[23]
- "Petrucelli also discovered that MG had been paying employees who weren't reflected on its payroll tax records. Petrucelli opined that MG had understated its income and misreported payroll tax records to the State of New Jersey creating potential exposure to Cabrera."[24]
- "On December 13, 2013, the court appointed Petrucelli as a monitor to report to the court on MG's financial status and accounting practices. On January 9, 2014, Petrucelli requested Hernandez's attorney to help compile financial records for his review. On January 31, 2014, Petrucelli reported to the court that the unreported sales tax liability from 2010-2013 was approximately $79,200 and the payroll tax liability for 2012-2013 was approximately $55,695. Petrucelli estimated the corporate income tax liability for 2010-2013 as $181,165. Petrucelli also recognized that there was an issue regarding unreported personal income tax liability and estimated the total estimated tax liability for 2010-2013 at $383,508.

[23] *Id*. at 9-10.
[24] *Id*. at 10.

Petrucelli estimated penalties and interest at $139,900 for a total tax liability of $523,498."[25]

- "Petrucelli submitted other interim reports to the court reflecting that reporting issues were getting resolved. On July 21, 2014, Petrucelli reported to the court that for the first time, that books, records and tax returns were finally synchronized."[26]
- "On September 5, 2014, Petrucelli reported to the court that MG's accounting procedures were finally within the scope required by State and Federal authorities. Petrucelli also noted that the main concern at this time was to address the potential liability of $523,497 that arose from the unreported sales and payroll tax liabilities of MG. Petrucelli also reported that he didn't have the point of sale information going back before 2014. For 2011, 2012 and 2013, he was able to add all the bank deposits, add all the cash reflected in the Ledger and recreate a cash ledger that led to his conclusions relative to tax liabilities."[27]
- "Petrucelli then started to report to the Arbitrator on the contributions by Cabrera and Hernandez. Specifically, Petrucelli testified that there was money that went into MG that was later moved to another venture to acquire property in another venue. For example, Petrucelli testified that he went back and tried to recreate

[25] *Id*.
[26] *Id*. at 11.
[27] *Id*.

contributions paid in cash for painting."[28]

- "The Arbitrator finds Petrucelli credible. His testimony was clear and cogent. Petrucelli implemented corrective measures to normalize MG's accounting practices and limit its tax liability."[29]
- "The existence of the Ledger and the admitted underreporting of sales and the cash payment to employees without the corresponding withholding tax reflect a poorly run business. It wasn't until the court appointed Petrucelli did MG begin to employ the most rudimentary accounting procedures. Petrucelli eventually employed basic and professional accounting practices in an attempt to mitigate MG's tax liabilities."[30]
- "Petrucelli testified that the difference in sales between the Ledger and what MG reported to the tax authorities was $849,248. Petrucelli testified that although there were some receipts attached to the Ledger for cash payments, he could not reconcile the entire amount of $849,248. Petrucelli determined that there was an under declaration of employees to the taxing authority. This fact exposes MG to substantial tax liabilities from state and federal officials. Petrucelli opined that MG, through Hernandez, concealed revenue. Hernandez is therefore responsible for all of Petrucelli's fees from the time of his appointment as monitor through the

[28] *Id*. at 12. This finding appears to be significant but it was not a part of Plaintiff's arguments for summary judgment and the Arbitrator's analysis relating to the transfer of assets out of MG and payments for painting are not set forth in detail in the record.
[29] *Id*.
[30] *Id*. at 34.

completion of his duties in this arbitration. For the above reasons, the Arbitrator accepts Petrucelli's calculations relative to each party's contributions to MG. Specifically, Cabrera contributed $903,360 to MG and Hernandez contributed $1,035,943 to MG. Cabrera received no distributions from MG."[31]

- "The Arbitrator accepts Petrucelli's calculations relative to MG's actual revenue for the following years: 2011- $919,096; 2012- $1,016,128; 2013 first and second quarters- $490,736. According to Petrucelli, the difference between MG's actual revenue and reported revenue is $849,248."[32]
- "Cabrera claims that the difference between actual revenue and reported revenue reflects a dissipation of corporate assets; Barson [an expert witness who was qualified as an expert in the fields of business valuation and forensic accountant] testified that this money went into Hernandez's pocket, although there was no direct evidence of this claim."[33]
- "MG did not have a liquor license during its first year of operation. By all accounts, business was slow during this time and it is more plausible that some of this unreported revenue was used to pay vendors. However, Petrucelli can only reconcile a portion of the difference as going to pay vendors."[34]
- "The logical inference is that Hernandez appropriated some of these funds for his

[31] *Id*. at 37.
[32] *Id*. at 38.
[33] *Id*.
[34] *Id*.

own use. Hernandez has breached his fiduciary duty to Cabrera by mismanaging MG and by the appropriation of the aforementioned funds. Because of this breach, $849,248 was not properly accounted for and reported. The Arbitrator accepts the logical inference that Hernandez misappropriated the vast amount of this amount. Specifically, Hernandez is responsible to pay Cabrera one-half of this amount or $424,624."[35]

- "Although Petrucelli testified that some of this revenue may have been used to pay vendors, Hernandez should not benefit from his poor accounting practices and is responsible for Cabrera's entire share."[36]
- "In the Second and Third counts of Cabrera's complaint, Cabrera alleges fraud, deceit, waste, conversion and self-dealing. The Arbitrator merges these allegations into the fourth, fifth and sixth counts. The Fourth and Fifth Counts allege Breach of Fiduciary Duty and Negligence through Mismanagement and unjust enrichment."[37]
- "Hernandez has caused damage to MG through his shoddy accounting practices. According to Petrucelli, MG has potential tax liability of between $300,000-$350,000 because Hernandez underreported sales revenue and the number of employees who worked at MG."[38]

[35] *Id*. at 38-39.
[36] *Id*. at 39.
[37] *Id*.
[38] *Id*.

- "Hernandez does not have 'clean hands' in this matter. Not only did he mismanage MG, he also misappropriated corporate assets." [39]
- "Because of his mismanagement of MG and misappropriation of MG's funds, Hernandez is removed as the operator of MG effective immediately."[40]
- "The Arbitrator has determined that Hernandez used faulty accounting methods and misappropriated MG's funds. He was responsible for the day to day operations of MG and Cabrera had a reasonable expectation that basic accounting methods would be utilized and corporate funds would not be misappropriated."[41]
- "Because of the faulty accounting procedures employed by Hernandez, MG faces a potential substantial tax liability that may be jointly shared by the shareholders. Because of these shoddy procedures, Cabrera could not ascertain the true financial status of MG and was required to bring the instant action. Through Petrucelli's corrective actions, Cabrera learned that Hernandez misappropriated MG's funds."[42]
- "The Arbitrator finds that Hernandez actions were 'vexatious or not in good faith.'" *Belfer v. Merling*, 322 N.J. Super. 124, 144 (App. Div. 1999).[43]

The Arbitrator's findings in the interim decision are clear with respect to the Debtor's financial mismanagement of MG. The decision also found that $849,248 of MG's funds were unaccounted for and made the "logical inference" that the Debtor misappropriated some of those

[39] *Id*. at 40.
[40] *Id*.
[41] *Id*. at 41.
[42] *Id*. at 42.
[43] *Id*.

funds for his own use. But, the Arbitrator recognized that there was no direct evidence that the Debtor took funds from MG and used them for his own purposes. The problem with the Arbitrator's interim findings is that, while they are very clear as to the Debtor's mismanagement and "shoddy" bookkeeping, they are less clear regarding the Debtor's intentional self-dealing. For example, the Arbitrator had before him Plaintiff's allegations of fraud and self-dealing in the second and third counts of Plaintiff's state court complaint. He could have made a specific finding of liability based on fraud or self-dealing but did not. Instead, the Arbitrator "merged" these counts with the counts for breach of fiduciary duty and negligence. We are left to speculate as to why the Arbitrator proceeded in this manner. It is probably because the case was so strong with respect to negligence and breach of fiduciary duty that a detailed analysis on the fraud and self-dealing claims were unnecessary.

In addition, while the Arbitrator found that the Debtor intentionally underreported sales to the state of New Jersey and failed to pay payroll taxes, Petrucelli eventually synchronized the books, records and tax returns using MG's handwritten ledger and brought MG's accounting practices within the form required by state and federal authorities. The Debtor's deliberate non-payment of taxes may be the basis for a non-dischargeability claim for any resulting sanctions, interest and fees, but the Arbitrator did not focus on this inquiry (because it was not necessary).

As for a determination of damages and costs, the Arbitrator and made the following determinations in his final decision that are relevant to the issue of dischargeability:

- "Pursuant to the decision, Hernandez was removed as the operator of MG and replaced by Cabrera or his designee. The Arbitrator also directed Hernandez to pay

$426,624.00 and allocated any tax liability equally between Cabrera and Hernandez. The Arbitrator also awarded Cabrera counsel fees and costs and directed Cabrera's counsel to provide a certification of services and costs to opposing counsel and the Arbitrator."[44]

- "On January 12, 2016, Cabrera's counsel provided a Statement of Damages to the Arbitrator and Hernandez's counsel. That document was marked BC-3 at the Hearing."[45]
- "On June l, 2016, Cabrera's counsel provided to the Arbitrator and Hernandez's counsel a Supplemental Damage Calculation and Remedy Statement and Supplemental Certification in Support of Counsel Fees that were marked at the Hearing as BC-5 and BC-6."[46]
- "Hernandez's counsel did not provide any opposition to the above referenced certifications."[47]
- "Petrucelli's services resulted in MG's books and records being kept in accordance

[44] Plaintiff's Mot. for Summ. J., Ex. O, at 2, ECF No. 9.
[45] *Id.* BC-3 states, in relevant part, "Hernandez promptly abandoned the compliant practices and procedures installed by the Monitor and returned to his own form of mismanagement. … Based upon Cabrera's discovery, the Arbitrator has directed that the Monitor conduct an analysis of the corporation's books and records for the period commencing July l, 2013 through December 29, 2015 for the purpose of uncovering and quantifying any additional losses." Plaintiff's Supplemental Submission in further support of Plaintiff's Mot. for Summ. J., Ex. D, at 7-8, ECF No. 14.
[46] *Id*. at 3. BC-5 states, in relevant part, "The Monitor reported actual revenues for the third and fourth quarters of 2014 were $530,328.11 but reported revenues were only $494,477.00, leaving $35,901.11 unaccounted for. Likewise the Monitor determined that actual revenues for 2015 were $969,271.90 but reported revenues were only $945,315.00, leaving $23,956.90 unaccounted for. Applying the Arbitrator's analysis as set forth in his Decision, the funds unaccounted for were misappropriated by Hernandez and Cabrera is entitled to a damage award against Hernandez in a sum equal to one-half of that amount or … ($35,901.11 + $23,956.90 ÷ 2)." Plaintiff's Supplemental Submission in further support of Plaintiff's Mot. for Summ. J., Ex. E, at 6, ECF No. 14.
[47] Plaintiff's Mot. for Summ. J., Ex. O, at 3, ECF No. 9.

with proper accounting standards. His services presumably blunted punitive tax consequences because of Hernandez's misappropriation of funds and shoddy recordkeeping."[48]

- "The Arbitrator has previously found that Hernandez acted fraudulently and illegally in his mismanagement of MG through the use of two (2) sets of books and the misappropriation of money."[49]
- "Cabrera is awarded the following sums against Hernandez:

  1. $454,553.00 - Misappropriation of funds by Hernandez from 2011 – December 29, 2015;

  2. $373,994.98 - Cabrera's Counsel fees;

  3. $51,587.59 - Petrucelli's fees;

  4. $9,743.93 - Monies owed pursuant to consent orders;

  5, $16,536.81 - Repayment of loan from Cabrera to Hernandez;

  6. $20,925 - Half of fees paid by Marinero Grill for Hernandez's attorney;

  7. $1,111.09 - One-half of the judgment amount to be paid by Cabrera; and

  The total award against Hernandez is $928,452.40."[50]

The Arbitrator's use of the phrase "acted fraudulently" in his final decision was emphasized by the Plaintiff in his argument. But, there is not a clear connection between this conclusion in the final decision (that the Debtor acted fraudulently) and the analysis in the interim decision, which

[48] *Id*. at 5.
[49] *Id*. at 7.
[50] *Id*. at 7-8. The state court judgment reduced the award to $880,404.01.

does not specifically address the fraud claims other than to infer that some of the unaccounted funds were taken by the Debtor.

**C. SUMMARY JUDGMENT ANALYSIS**

Pursuant to Federal Rules of Civil Procedure 56(c), a motion for summary judgment will be granted "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." "The summary judgment movant must show initially that there is no genuine issue of material fact."[51] The Plaintiff attempts to satisfy this burden by applying collateral estoppel to the above findings of the Arbitrator. For the Court to grant non-dischargeability at summary judgment under collateral estoppel, the Arbitrator's factual findings must establish all the necessary elements under 11 U.S.C. §§ 523(a)(4), 523(a)(6), 727(a)(3) or 727(a)(5). "Once the movant has met that initial burden, the nonmovant must present evidence establishing that a genuine issue of material fact exists, making it necessary to resolve the difference at trial."[52]

"A court must view the evidence in the light most favorable to the nonmovant when deciding a summary judgment motion."[53] But, "[t]he nonmovant, rather than rely on mere allegations, must present actual evidence raising a genuine issue of material fact."[54] For example, the Debtor certifies that "[t]here were cash expenses that were not taken into consideration in the

[51] *Knauss v. Dwek*, 289 F. Supp. 2d 546, 549 (D.N.J. 2003) (citing *Celotex Corp. v. Catrett*, 477 U.S. 317, 323 (1986)).
[52] *Id.* (citing *Celotex Corp.*, 477 U.S. at 324).
[53] *Id.* (citing *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986)).
[54] *Id.* (citing *Anderson v. Liberty Lobby*, 477 U.S. 242, 249 (1986)).

reconciliation of MG's financial records. Had Petrucelli taken these cash expenses into consideration, there would be an accounting of most, if not all, of the misappropriated funds in question."[55] Yet, the Debtor fails to provide any specific details or evidence and his language also leaves open the possibility that an accounting would be unable to reconcile all of the misappropriated funds. As stated above, the Arbitrator already considered such a possibility and determined that, "[a]lthough Petrucelli testified that some of this revenue may have been used to pay vendors, Hernandez should not benefit from his poor accounting practices and is responsible for Cabrera's entire share."[56] Thus, if the Debtor misappropriated any of MG's funds for himself, this Court should not allow him to benefit from his own poor accounting practices which may render the exact amount indeterminable. Still, the issue remains whether the Arbitrator's findings warrant the entry of summary judgment. The record establishes that the Debtor mismanaged MG, kept poor records and deliberately failed to pay taxes while he was in a fiduciary relationship with the Plaintiff. It also establishes that it is likely some of the missing funds were taken from MG for the Debtor's personal use. Because the amount of misappropriated funds is unknown, it is difficult in a summary judgment context to fix an amount of the non-dischargeable debt to the Plaintiff or find that the Debtor has made material misstatements or omissions in his bankruptcy filings.

1. 11 U.S.C. § 523(a)(4)

Pursuant to § 523(a)(4), the Debtor is not eligible for a discharge of a debt resulting from "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." In this case,

[55] Certification of Abel Hernandez in Support of Opposition to Plaintiff's Mot. for Summ. J., ¶ 18, ECF No. 11.
[56] Plaintiff's Mot. for Summ. J., Ex. N, at 39, ECF No. 9.

the Plaintiff claims that the debt resulted from fraud or defalcation. The Debtor admits he was acting in a fiduciary capacity but denies he committed a fraud or defalcation. Rather, he argues the acts that led to the judgment were not intentional and, if anything, were the result of negligence.

The Court cannot ignore the language used by the Arbitrator in his final decision which stated that he "previously found that Hernandez acted fraudulently and illegally in his mismanagement of MG through the use of two (2) sets of books and the misappropriation of money."[57] However, the Arbitrator failed to specifically identify fraudulent activity in the interim decision other than to infer that some of the missing funds went directly to the Debtor.

Plaintiff argued that the Debtor made a conscious decision to staff MG with undocumented employees, pay them in cash and keep them off MG's books due to low sales.[58] The Debtor admitted that he knew he must withhold taxes on behalf of his employees but elected not to report the taxes of his off the book employees due to a poor economy.[59] In addition, he consciously made the decision to underreport sales revenue to the taxing authorities and MG's ledger did not correspond to the tax returns he was filing on behalf of the business.[60] Even worse, the Debtor returned to his poor accounting practices upon retaking control of the books from Petrucelli from July 1, 2013 through December 29, 2015.[61] The Plaintiff argues that these admissions and patterns of behavior establish fraud or defalcation because they resulted in tax liabilities. However, the

[57] Plaintiff's Mot. for Summ. J., Ex. O, at 7, ECF No. 9.
[58] Plaintiff's Supplemental Submission in further support of Plaintiff's Mot. for Summ. J., Ex. B, at 1017:13-21, ECF No. 14.
[59] *Id*. at 1097:1-24.
[60] *Id*. at 1098:5-19; 1098:20; 1099:22.
[61] *Id*., Ex. D, at 7-8.

Arbitrator's award of fees and damages stem from the Plaintiff's 50% share of the unaccounted for funds and not for potential tax liability. Furthermore, while the above acts likely rise to the level of fraud, that fraud is against the taxing authorities and not the Plaintiff. As far as the Court is aware, none of the Plaintiff's claim relates to tax liability paid to or still owed to the taxing authorities. As set forth above, the Plaintiff has an argument that any penalties, interest and fees relating to the Debtor's willful non-payment of taxes might be non-dischargeable.

Otherwise, the only time the Arbitrator mentions fraud in the interim decision is as follows: "the Second and Third counts of Cabrera's complaint, Cabrera alleges fraud, deceit, waste, conversion and self-dealing. The Arbitrator merges these allegations into the fourth, fifth and sixth counts. The Fourth and Fifth Counts allege Breach of Fiduciary Duty and Negligence through Mismanagement and unjust enrichment."[62] The record is unclear whether the merged counts were granted in their entirety. The Court is also not convinced there was a specific finding of fraud (as opposed to an inference) when the decisions are looked at in totality.

As for defalcation under § 523(a)(4), the Supreme Court has clarified that it requires "a culpable state of mind" with a "knowledge of, or gross recklessness in respect to the improper nature of the relevant fiduciary behavior."[63]

In *Bullock*, the Supreme Court stated that the statutory term "defalcation" should be treated as such:

> "[W]here the conduct at issue does not involve bad faith, moral turpitude, or other immoral conduct, the term requires an intentional wrong. We include as intentional not only conduct that the fiduciary

[62] Plaintiff's Mot. for Summ. J., Ex. N, at 39, ECF No. 9.
[63] *In re Truch*, 508 B.R. 616, 625 (Bankr. D.N.J. 2014) (citing *Bullock v. Bank Champaign, N.A.*, 569 U.S. 267 (2013)).

> knows is improper but also reckless conduct of the kind that the criminal law often treats as the equivalent. Thus, we include reckless conduct of the kind set forth in the Model Penal Code. Where actual knowledge of wrongdoing is lacking, we consider conduct as equivalent if the fiduciary 'consciously disregards' (or is willfully blind to) 'a substantial and unjustifiable risk' that his conduct will turn out to violate a fiduciary duty. ALI Model Penal Code § 2.02(2)(c) … That risk 'must be of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation.' *Id*…. *Cf. Ernst & Ernst v. Hochfelder*, 425 U.S. 185, (1976) (defining scienter for securities law purposes as 'a mental state embracing intent to deceive, manipulate, or defraud')."[64]

Here, the Plaintiff relies on the Arbitrator's logical inference that the Debtor misappropriated funds for his own personal use or benefit as establishing the defalcation claim. The Court agrees that if the Debtor misappropriated funds for his own use it would be an intentional and improper act. Yet, as already mentioned, there is no direct evidence that this occurred. Therefore, to grant summary judgment based on fraud or defalcation, the Court would have to rely on the Arbitrator's logical inference.

The Plaintiff asserts that the Third Circuit authorized the use of inferences in *Aiello v. Aiello (In re Aiello)*. In *Aiello*, the Third Circuit found that intent "must be gleaned from inferences drawn from a course of conduct."[65] But in *Aiello*, there was direct evidence that the executor of an estate committed "blatant acts of self-dealing" by using the assets of the estate to benefit his own interests related to stock purchases in entities of which he had an interest, loan forgiveness,

[64] *Bullock*, 569 U.S. at 273-74.
[65] *Aiello*, 660 F. App'x at 183 (quoting *Rosen v. Bezner*, 996 F.2d 1527, 1534 (3d Cir. 1993)).

and the conveyance of three of the estate's properties to himself, his brother, and his brother's family trust without consideration.[66] That is easily distinguishable from the Arbitrator's logical inference in this case. Thus, the Court is unable to make the necessary determination about the Debtor's state of mind to find defalcation and a genuine issue of material fact exists as to the amount of the misappropriated funds that went directly to the Debtor.

2. 11 U.S.C. § 523(a)(6)

Pursuant to § 523(a)(6), the Debtor is not eligible for a discharge of a debt resulting from "willful and malicious injury by the debtor to another entity or to the property of another entity." "This exception from discharge applies only to acts done with actual intent to cause injury."[67] Here, the Arbitrator found that the Debtor's actions were "vexatious or not in good faith"[68] but makes no finding of actual intent to cause willful injury to the Plaintiff. The Court cannot infer such intent under the collateral estoppel doctrine but agrees that if the Debtor misappropriated MG's funds for his own use that it would constitute willful and malicious injury to the Plaintiff. Again, there is an issue of fact as to the amount of the misappropriated funds.

3. 11 U.S.C. § 727(a)(3)

"Completely denying a debtor his discharge, as opposed to avoiding a transfer or declining to discharge an individual debt pursuant to § 523, is an extreme step and should not be taken lightly."[69] Pursuant to § 727(a)(3), a discharge will not be granted if "the debtor has concealed,

[66] *Aiello*, 660 F. App'x at 180-81.
[67] *Casini v. Graustein (In re Casini)*, 307 B.R. 800, 820 (Bankr. D.N.J. 2004) (citing *Kawaauhau v. Geiger*, 523 U.S. 57 (1998)).
[68] Plaintiff's Mot. for Summ. J., Ex. N, at 42, ECF No. 9.
[69] *Rosen*, 996 F.2d at 1531.

destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case." The Third Circuit addressed § 727(a)(3) in *Meridian Bank v. Alten* and determined that to establish a claim under § 727(a)(3), "a creditor objecting to the discharge must show (1) that the debtor failed to maintain and preserve adequate records, and (2) that such failure makes it impossible to ascertain the debtor's financial condition and material business transactions."[70]

Notwithstanding the above, the Bankruptcy Code does not require a debtor to maintain "an impeccable system of bookkeeping." "The test is whether 'there [is] available written evidence made and preserved from which the present financial condition of the bankrupt, and his business transactions for a reasonable period in the past may be ascertained.'" In other words, the Debtor's "records must sufficiently identify the transactions [so] that intelligent inquiry can be made of them."[71]

The Debtor asserts that he testified competently at the meeting of creditors and responded to all inquiries made by Plaintiff's counsel and the Office of the U.S. Trustee. He also asserts that the Plaintiff has not demanded any discovery in this case. The Plaintiff responded that discovery was unnecessary due to the extensive state court litigation and argued that based on the Arbitrator's findings, the Court has sufficient grounds to deny the Debtor a discharge under § 727(a)(3).

[70] *Meridian Bank v. Alten*, 958 F.2d 1226, 1232 (3d Cir. 1992).
[71] *Meridian Bank*, 958 F.2d at 1230.

The record is clear that "Petrucelli visited MG on August 14, 2013 and looked for normal accounting records, such as an electronic ledger, tax returns and payroll records to determine if sales tax, payroll taxes and corporate taxes were being paid. When Petrucelli reviewed the tax return, it did not correlate with documents he had been given. Petrucelli testified that he took bank records and attempted to establish the total to gross receipts and found large disparities. According to Petrucelli, MG's bookkeeper, Nuria Gonzalez, had everything written out but the handwritten document did not reconcile with the electronic QuickBooks. … Petrucelli found that older records had been purged requiring him to retrieve bank records and create financial records. Petrucelli was able to capture some data to roll forward and attain a comfort level that certain numbers should be reported and that proper accounting procedures should be implemented."[72] Thus, the Plaintiff probably satisfied the first element because it is clear "that the debtor failed to maintain and preserve adequate records," with respect to MG's affairs.

As for the second element, the Plaintiff suggests that if the Debtor maintained sufficient records, he would be able to account for the disposition of the $849,248 that passed through his hands while managing MG. This argument relies on the premise that the Debtor took funds for his personal benefit and has deliberately omitted these funds from his bankruptcy petition to shield them from his creditors. While the Arbitrator made a logical inference that this occurred, he also conceded that there was no direct evidence despite Petrucelli's in-depth look in to MG's accounting practices and records.

[72] Plaintiff's Mot. for Summ. J., Ex. N, at 9, ECF No. 9.

Notably, Petrucelli successfully synchronized the books, records and tax returns and brought MG's accounting practices within the scope required by state and federal authorities. In addition, the Debtor has already declared under penalty of perjury that the information in is bankruptcy filings is true and correct and acknowledged that a false statement, concealing property or obtaining money or property by fraud in connection with a bankruptcy case can result in fines or imprisonment.[73] The Court must view the "evidence in the light most favorable to the nonmovant when deciding a summary judgment motion."[74] It is also worth noting that the Arbitrator's findings relate to a state of affairs that existed at least 1 year before the Debtor filed his bankruptcy petition. Therefore, the Court finds that there exists a genuine issue of material fact as to whether the missing funds relating to MG "makes it impossible to ascertain the debtor's financial condition and material business transactions."[75]

4. 11 U.S.C. § 727(a)(5)

Pursuant to § 727(a)(5), a discharge will not be granted if "the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor's liabilities." "Similar to section 727(a)(3), the analysis under § 727(a)(5) uses a burden shifting framework."[76] "The objecting party must first make a showing that the debtor 'at one time owned substantial and identifiable assets that are no longer

[73] Chapter 11 Voluntary Pet., *In re Abel Hernandez*, No. 17-16556 (JKS), ECF No. 1.
[74] *Id.* (citing *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986)).
[75] *Meridian Bank v. Alten*, 958 F.2d 1226, 1232 (3d Cir. 1992).
[76] *In re Jacobs*, 381 B.R. 147, 168 (Bankr. E.D. Pa. 2008).

available to his creditors.' Once that burden has been satisfied, it shifts to the debtor to offer a 'satisfactory explanation' for the unavailable assets."[77]

Here, the Plaintiff asserts that the "loss of assets or deficiency of assets" are the misappropriated funds from MG that the Debtor may have used or retained for his own benefit. Though the Arbitrator inferred that some of the missing funds were used for the Debtor's benefit, the amount is still unclear. Also, whether any of those funds would be available to satisfy the Debtor's liabilities (as opposed to MG's liabilities) remains unresolved. To satisfy the elements of § 727(a)(5), the Plaintiff must show evidence that the Debtor possessed the misappropriated funds and that they are no longer available to his creditors. The findings of the Arbitrator do not establish these elements for summary judgment purposes.

## CONCLUSION

The Court denies Plaintiff's motion for summary judgment. At trial, the Court shall consider the Arbitrator's interim and final decisions as part of the record. A significant issue of material fact to be determined at trial will be whether (and how much of) the misappropriated funds from MG went to the Debtor for his own use.

[77] *Id*. (quoting *In re Wasserman*, 332 B.R. 325, 333 (Bankr. N.D. Ill. 2005)).

Form order − ntcorder

**UNITED STATES BANKRUPTCY COURT**

District of New Jersey
MLK Jr Federal Building
50 Walnut Street
Newark, NJ 07102

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In Re: Abel Hernandez
Debtor

Case No.: 17−16556−JKS
Chapter 7

Bernabe Cabrera
Plaintiff

v.

Abel Hernandez
Defendant

Adv. Proc. No. 17−01721−JKS

Judge: John K. Sherwood

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**NOTICE OF JUDGMENT OR ORDER**
**Pursuant to Fed. R. Bankr. P. 9022**

Please be advised that on June 25, 2018, the court entered the following judgment or order on the court's docket in the above−captioned case:

Document Number: 17 − 9
DECISION AND ORDER DENYING PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT (Related Doc # 9). Service of notice of the entry of this order pursuant to Rule 9022 was made on the appropriate parties. See BNC Certificate of Notice. Signed on 6/25/2018. (env)

Parties may review the order by accessing it through PACER or the court's electronic case filing system (CM/ECF). Public terminals for viewing are also available at the courthouse in each vicinage.

Dated: June 25, 2018
JAN: env

Jeanne Naughton
Clerk