UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

NOT FOR PUBLICATION

In re: ROGER E. BENDELAC,	:	
	:	Chapter 7 Case No. 03-10023
Debtor.	:	
	:	
CHARLES WALLET, PASCAL WALLET and WALCO & CIE,	:	
	:	Adv. Proc. No. 03-02457 (CGM)
	:	
Plaintiffs,	:	
	:	
- against -	:	
	:	
ROGER E. BENDELAC,	:	
	:	
Defendant.	:	

MEMORANDUM DECISION AFTER TRIAL

A P P E A R A N C E S :

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CECELIA G. MORRIS
UNITED STATES BANKRUPTCY JUDGE

Over the course of four days, the Court conducted a trial in this adversary proceeding to determine whether certain debt is dischargeable under Section 523(a)(4) of the Bankruptcy Code. Section 523(a)(4) excepts from discharge "any debt" that was incurred "for fraud or defalcation

while acting in a fiduciary capacity, embezzlement, or larceny." Only "fraud or defalcation while acting in a fiduciary capacity" is alleged in this adversary proceeding.[1]

Upon hearing the evidence, reviewing the testimony and examining the documents as set forth below, at best Plaintiffs have shown that at times the Debtor acted as plaintiffs' agent in a manner that also benefited the Debtor and Laidlaw (defined below), another entity with which the Debtor was associated. Due to the narrow interpretation of the word "fiduciary" under Section 523(a)(4), the Debtor did not owe Plaintiffs a fiduciary duty within the meaning of the statute; specifically, no express or technical trust existed, which is normally a prerequisite to finding that a fiduciary duty was owed under Section 523(a).

Putting aside for the moment the technicalities of what constitutes a "fiduciary duty" under Section 523(a)(4), the Plaintiffs simply failed to show that the Debtor committed a defalcation, generally defined in the Second Circuit as inherently wrongful, illicit or morally reprehensible, or at least constituting willful neglect, recklessness or gross negligence. After hearing and reviewing the evidence and record in this case, the Court believes that the investments handled by the Debtor were made with, at a minimum, the implied approval of the Plaintiffs. Plaintiffs' testimony as to what was and was not authorized is contradictory. By comparison, the Court found the Debtor's testimony to be knowledgeable and credible. The Court also finds that the investment entities created by Plaintiffs and Debtor were formed with the intention of pursuing high-risk investments; the testimony as well as the factual chronology reveals that Plaintiffs did not raise a strong protest against the Debtor's investment decisions until they proved unprofitable.

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[1] Trial Transcript, January 12, 2005 at 8. Plaintiffs' Amended Complaint dated May 5, 2003 is broken into five counts, but each count seeks relief based upon defalcation while acting in a fiduciary capacity. The issues of law in the Joint Pre-Trial Order dated July 27, 2004 and Plaintiff's proposed conclusions of law submitted after trial address whether the Debtor owed Plaintiffs a fiduciary duty and whether a defalcation occurred.

Most problematic is the total lack of evidence as to the amount of damages for which the Debtor should be liable, particularly given the overall condition of the market during the relevant time periods. Section 523(a)(4) only excepts "debt" relating to a defalcation while acting in a fiduciary capacity. As Debtor's counsel stated at the conclusion of Plaintiff's evidence at trial, Plaintiffs made "no distinction in the amount of damages claimed due to market conditions or due to any act of [the Debtor], and there's been no testimony to identify specifically any damages that occurred because of any act of [the Debtor]." March 24, 2005 Trial Transcript, p. 266. "They're claiming that the account diminished, but the diminution of an account does not in itself lay that at [the Debtor's] doorstep. There has to be some causation or nexus between acts that [the Debtor] is claimed to have done and any loss that was suffered, and that's totally lacking in any testimony here." *Id*. at 267.

Thus, Plaintiffs have failed to carry their burden of proof under the "well-established interpretational rule that exceptions from discharge are to be strictly construed so as to give maximum effect to the policy of the bankruptcy code to provide debtors with a 'fresh start'." *Kawaauhau v. Geiger (In re Geiger)*, 113 F.3d 848, 853 (8th Cir. 1997), *aff'd*, 523 U.S. 57 (1998).

Jurisdiction

This Court has subject matter jurisdiction pursuant to 28 U.S.C. § 1334(a), 28 U.S.C. § 157(a) and the Standing Order of Reference signed by Acting Chief Judge Robert J. Ward dated July 10, 1984. A determination as to the dischargeability of a debt is a "core proceeding" under 28 U.S.C. § 157(b)(2)(I).

The adversary proceeding was reassigned to this Court from the Hon. Arthur J. Gonzalez on April 12, 2004.

Background and Discussion

The trial in this case commenced on January 12, 2005. On January 13, 2005, at the parties' consent, the trial was adjourned to March 23, 2005. The trial resumed on March 23, 2005[2] and concluded on March 24, 2005. The parties completed post-trial submissions on June 16, 2005. The following are the Court's findings of facts and conclusions of law pursuant to Fed. R. Bankr. P. 7052.

For much of the four-day trial Plaintiffs' testimony resembled more of an anthology than a cohesive narrative. The evidence presented by the Plaintiffs bore little or no relation to the core of Plaintiffs' dischargeability complaint. The best summary of Plaintiff's allegations came at the conclusion of Plaintiffs' testimony on the fourth day of trial:

> Mr. Bendelac was retained to provide investment advice on behalf of [] these various entities, by the plaintiffs, Wallet as an individual, RBCW, subsequently Walco/WPC, he was being compensated for that. He said two percent interest, which he says varies from time to time but he's being compensated for his management advice.
>
> He was also, during the relevant period, chairman, chief executive officer, chief financial officer of the Laidlaw entity here, that, according to its own filings, was a registered investment adviser. As an officer of that corporation, he and the corporation had various obligations prior to many of these transactions to provide disclosures to the Wallets concerning potential conflicts of interest in terms of the requirements that they receive authorizations to make certain transactions because it was clear that there was an inherent conflict of interest here in the sense that Mr. Bendelac testified, and it's undisputed, he owned hundreds of thousands of shares and options to purchase other shares. So it was most definitely in his interest that the share price of Laidlaw be maintained.
>
> Now, what happened here? We have testimony that first exercise of unauthorized transactions – and the testimony of Mr. Wallet is that these were unauthorized transactions – the conversion of these Laidlaw bonds. Now, again, that was done most definitely in the interest of Mr. Bendelac; he most definitely had his own interest that this happen. The conversion of notes to

[2] At this point, attorney David Robinson and the New York firm of Robinson & Cournot replaced Randall Anderson and the London firm of Keogh Caisley as Plaintiffs' trial counsel.

shares most definitely improves the situation of Laidlaw, improves its balance sheet, takes what's shown as a debt and now becomes equity and improves the financial health, at least on paper, of the company and therefore has a tendency to improve its share price, which is something that Mr. Bendelac most definitely has an interest in.

That was 1999. We then go through 2000, 2001 and into 2002, with a series of share purchases of Laidlaw, which Mr. Wallet testified were unauthorized, which results ultimately in the accounts and portfolios of the remaining entities that held the portfolios, WPC and Walco, being essentially investments in Laidlaw and nothing else; virtually no diversification.

In addition to being very bad advice and rising the level of gross negligence, recklessness and so on, from a management – from an account management and portfolio management standpoint, there's also a fiduciary duty problem here, because there was also an inherent conflict of interest. It would be bad enough if this had been done, taking this entire portfolio and putting it into Laidlaw, even if Mr. Bendelac had no interest in Laidlaw, because now he's doing an act of gross negligence and recklessness by putting these accounts at the mercy of the health and success of Laidlaw.

But of course it was much, much worse than that in that Laidlaw was not just a company. It was a company in which Mr. Bendelac, throughout this entire period, had a substantial financial interest.

He never disclosed all of this, all these transactions that were unauthorized. He was not disclosing to the Wallets that he was buying Laidlaw, buying Laidlaw, buying Laidlaw. As he was doing it, the price of Laidlaw was going down. He was trying to support that price because he had a personal vested interest in doing it.

The price of Laidlaw collapsed and the portfolio collapsed and the result is that the investment that Mr. Wallet said was approximately $1,230,000 that was sent over here to be managed by Mr. Bendelac is essentially worthless today, worth a few thousand dollars.

March 24, 2005 Trial Transcript (hereafter, "3/24 Tr.") at 161-165. The remainder of the factual discussion tracks the contentions in the summary quoted above, and as outlined in Plaintiffs' proposed findings of fact and conclusions of law submitted following the trial.

A. The Parties and Other Investment and Management Entities

The identification of the following persons and entities are, for the most part, not in dispute:

- Individual plaintiffs Charles Wallet and Pascal Wallet claim to have invested a total of approximately $1,242,000 "for investment management" with the Debtor, either directly or through various entities such as Walco, WPC and RBCW (each defined

below). Charles Wallet placed approximately $406,000 and Pascal Wallet placed approximately $306,000. Pascal Wallet testified that the Wallets have known the Debtor since at least 1991. Of the Plaintiffs, Pascal Wallet is most familiar with the facts relevant to this adversary proceeding.[3]

- Plaintiff Walco & Cie ("Walco") is a corporation organized under the laws of France, with a principal place of business in Paris, France. Walco became a limited partner in RBCW (defined below) by investing $100,000 in April 1994. Walco eventually invested a total of approximately $530,000.
- RBCW LP, a New York limited partnership, was formed by the Debtor at least prior to April 1994; RBCW LLC replaced RBCW LP in approximately January 1997. (RBCW LP and RBCW LLC are referred to collectively as "RBCW").
- The general partner of RBCW LP was Genersis Associates, Inc. ("Genersis"), which was owned and controlled by the Debtor.
- At some point, equity ownership of RBCW LLC was transferred to Pascal and Charles Wallet, except for a 2% ownership interest held by Epsilog Corp. ("Epsilog"), the managing member. Epsilog was a corporation owned and controlled by the Debtor. The extent of Epsilog's ownership interest and whether and how it could fluctuate is not clear. See Debtor's testimony, 3/23 Tr., 157-159, 316; 3/24 Tr., 220-231.
- WPC Capital Ltd.[4] (hereafter, "WPC"), was formed by the Debtor as a Cayman Islands corporation. Genersis was the sole director of WPC and had legal control of its affairs. Genersis received compensation as a director. Pascal and Charles Wallet owned all of the equity interest in WPC. Pascal Wallet testified that he agreed to formation of WPC because he "had total trust in [Bendelac]." January 12, 2005 Trial Transcript (hereafter, "1/12 Tr."), 24.
- On or about December 31, 1999, RBCW was terminated, and its assets were placed in WPC.
- The Debtor testified that in July 1997 he joined Laidlaw Global, a subsidiary of Laidlaw Holdings, Inc. (collectively, "Laidlaw"), as a registered representative. March 24, 2005 Trial Transcript (hereafter "3/24 Tr."), 324. Toward the end of 1998 the Debtor testified that he "started having more responsibility" at Laidlaw, and his larger responsibilities came on or about May or June 1999. 3/24 Tr., 324. The Debtor

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[3] Plaintiffs state in their October 8, 2004 "Motion to Allow Charles Wallet to be Excused From Appearing at Trial":

> Charles Wallet, although a party in interest, was not a participant in events relevant to either the prosecution or defense of this Adversary Proceeding. He knows little about what happened because he entrusted the matter, which is the subject of this lawsuit, to his son Pascal Wallet, who will appear at trial.

By Memorandum Decision and Order dated December 30, 2004, the Court denied the motion to excuse Charles Wallet's testimony, and he did testify briefly on March 24, 2005.

[4] Sometimes referred to in documents as PCW Capital.

> testified that he became the chief operating officer of Laidlaw Holdings in May or June 1999. 3/23 Tr., 118.

According to the testimony of Pascal Wallet, the Debtor made all investment decisions for RBCW and WPC. 3/23 Tr., 55. Those investment decisions were made through the Debtor's companies, Genersis and Epsilog. Pascal Wallet testified that the Debtor had discretionary authority to trade in Walco (1/12 Tr. 38-39), but he also testified that he, not the Debtor, made the investment decisions for Walco (3/23 Tr. 55).

B. Investment in Laidlaw Bonds

Plaintiffs' Exhibit 25 is an undated letter from the Debtor to Pascal Wallet, calling his attention to:

> [T]he terms of the offer concerning the "Laidlaw Holdings, Inc." Units made up of Notes attached to warrants, yielding 12% a year. Laidlaw is an entity which has existed continuously in the USA since 1842. It is an investment bank, with a sound capital, since its primary shareholder is a company from Taiwan, with a capital value of +5 billion dollars.

Between November 1997 and January 1999 Plaintiffs claim the Debtor "caused" Plaintiffs to purchase a total of $832,905 in bonds issued by Laidlaw Holdings or its subsidiary, H&R Acquisition Corp. ("H&R"). Plaintiff's FFCL, p. 2. Plaintiff's Exhibit 148 is a chart detailing the nine separate purchases of Laidlaw and H&R bonds between July 14, 1997 and December 31, 1998.

Although Plaintiffs claim the Debtor advised them to purchase Laidlaw bonds (1/12 Tr. at 25-27), the only purchase of Laidlaw bonds that Plaintiffs claim was not authorized by them was Walco's September 30, 1998 purchase of $15,000 in Laidlaw Holdings bonds. 1/12 Tr. at 34-35. Pascal Wallet testified that he authorized a wire transfer purchase by Walco of $98,400 in Laidlaw bonds on May 2, 1998. 3/23 Tr. at 91-92; Joint Trial Exhibit (hereafter "Jt. Ex.") 109.

Plaintiffs claim the Debtor did not disclose that H&R Acquisition Corp. was related to Laidlaw Holdings or that Laidlaw owned approximately 81% of H&R Acquisition Corp. 1/12 Tr. at 33. Walco purchased $100,000 of H&R Acquisition Corp. bonds on January 1, 1998.

C. Alleged Unauthorized Transactions

Plaintiffs claim that the Debtor engaged in various unauthorized transactions (including conversion of some of the Laidlaw bonds and subsequent purchase of Laidlaw stock discussed below) and refused to provide statements for the WPC account.

Inconsistent with this claim is Pascal Wallet's testimony that the Debtor had "discretionary authority" to trade securities in the Walco account: "He was doing it. At this point we didn't have any conflicts with him." 1/12 Tr., 38-39. Pascal Wallet also testified that he did not normally authorize every purchase, and that he believed the debtor had the legal authority to make trading decisions for WPC and RBCW:

> Q: Do you normally authorize every purchase?
>
> A: No. At the beginning when I would send the money, it was for a specific investment.
>
> * * *
>
> Q: Who did you understand had the legal authority to make the trading decisions for WPC Capital?
>
> A: Well, I think it was Roger Bendelac.
>
> Q: And who had the legal authority to make trading decisions for RBCW?
>
> A: Roger Bendelac.

1/12 Tr., 38. There was not testimony or evidence that Wallet changed the terms of this understanding until much later, after the losses had occurred. The Debtor also testified that he believed he had discretionary authority to trade in Walco and WPC. 3/24 Tr. at 247.

Plaintiffs claim that, in spite of numerous requests, they only received two monthly statements concerning WPC. Plaintiff's FFCL, p. 3. Pascal Wallet testified that he did not

regularly receive reports on WPC investments and that although he asked the Debtor for them he received "very few". 1/12 Tr. at 47. Pascal Wallet does not dispute that he received all of the Walco statements directly at his office in Paris. 3/23 Tr. at 105.

Concerning the WPC accounts, Pascal Wallet was asked:

> Q: Did you ever write to any of the brokerage houses that were handling the WPC account and request that a copy of the statement be sent to you in Paris?
>
> A: I was always sending letters asking about the present situation, either a letter or a fax. Not specifically on the WPC, but the whole set of – what can I say – all the holdings."
>
> Q: But there was never a letter sent to any of the brokerage houses requesting a copy of the statement be sent every month directly to Paris? Correct?
>
> A: My intermediary in all of this was Roger Bendelac, so I was asking Roger Bendelac to send me that.

3/23 Tr. at 106.

The Debtor testified that Pascal Wallet's claim he was not receiving WPC statements was "an absolute lie" 3/24 Tr. at 204. According to the Debtor, Pascal Wallet received the WPC statements "under a covered envelope" because he "had not disclosed the WPC Cayman Islands account to the French tax authorities, and as a result he didn't want to receive directly, the mail on that." 3/24 Tr. at 204. Debtor testified that the WPC statements were sent at Pascal Wallet's request to an address at Lexington Avenue, in New York City, and that whenever Pascal called Debtor's assistant, Aline de Laforcade, "he could receive the statement directly from her in my absence at any time." 3/24 Tr. at 204. The parties dispute whether or not Pascal Wallet really requested that the WPC statements be delivered to a New York address under a code name "Gestilac." In denying that they requested delivery under the name Gestilac, Plaintiffs have suggested that the word "Gestilac" was chosen by the Debtor, a combination of a word meaning "management" in French and the last three letters of the Debtor's last name. Joint Exhibit 95 is a memorandum of understanding from Epsilog to the members of RBCW and recites that

"Gestilac is a code name chosen by the Wallets to refer to their WPC Capital Ltd interest in the UBS account and does not constitute a separate entity and is not related to any third party entity."

The parties also submitted the deposition of Aline de Laforcade. Ms. Laforcade recalls sending statements for WPC to a Mr. Wallet, although she could not recall the first name. Laforcade Deposition, p. 7. She testified that this was "not something that was monthly necessarily, just I recall having done that," and was not sure whether the Debtor would have done this himself when he was in the office. *Id.* at 10. When Ms. Laforcade was asked: "So whenever [Wallet] would have called you, you would have sent him the fax" she answered: "My job was to give information to customers on the market, on the account, especially if nobody else was there to take care of the calls. If Rodger [Bendelac] was out of the office it would be me." *Id.*

The Debtor further testified that Pascal Wallet "received information from me on a regular basis," and that: "Mr. Wallet is not the type of fellow who's not going to be checking on everything, so he did." 3/24 Tr. at 203. After observing Pascal Wallet's demeanor and testimony, the Court agrees with the Debtor's characterization. The Court is not persuaded that Pascal Wallet was prevented from receiving WPC account information.

D. Conversion of Laidlaw Bonds

By mid-1999, all Laidlaw and H&R Acquisition Corp. bonds held by RBCW, WPC and Walco were converted to Laidlaw stock. 3/24 Tr. at 185. Plaintiffs claim to have authorized the conversion of $300,000 worth of Laidlaw bonds "based on defendant's advice". *Id.* Pascal Wallet testified that he asked the Debtor whether to transfer $300,000 in bonds held in an account at UBS in Switzerland, an account for which the Debtor did not have investment authority. According to Pascal Wallet's testimony, the Debtor "told me that it was an interesting

operation, that that company was solid, and that the price of the transformation or the change or the rate was interesting, so we should do it." 3/23 Tr., 46.

Plaintiffs also claim that the Debtor did not inform them that the Laidlaw stock would be restricted and could not be sold for one year. Plaintiff's FFCL, p. 2-3. Pascal Wallet testified that he was not informed of the type of stock that would be received on conversion: "Mr. Bendelac was somebody I trusted. It was a telephone conversation. He told me that, effectively, it was an opportunity and that we should do it." 3/23 Tr., 49.

The Debtor's testimony is that: "There was a document that Walco & Company had to sign, the same document that UBS signed, that explained that upon conversion, you were obtaining restricted stock under Rule 144 [of the Securities Act of 1933], and therefore Mr. Wallet was well cognizant that any conversion would result in the retention of restricted stock for one year under Rule 144." 3/24 Tr. at 175. In support of his contention, Debtor offered proof of Pascal Wallet's authorization in November 1997 of a private placement subscription agreement in Jinpan International Limited and Laidlaw Global Securities, Inc. on behalf of Walco. The Jinpan investment was an investment of restricted stock similar to the Laidlaw shares. 3/23 Tr. at 114; Jt. Ex. 164.

By contrast, Pascal Wallet testified that he was "not in agreement" that the other bonds under the Debtor's control should be converted. 3/23 Tr. at 46-47. The Debtor admitted that there was no documentary proof that the conversions were authorized (3/24 Tr. at 186-187), but that he discussed the conversion with Pascal Wallet and possibly Charles. 3/24 Tr. at 308. "But basically the discussion was that at the time everybody was ecstatic because they thought, and everybody thought, that the good times would last forever and that none of us perceived that the stock would go from a high of 30 at the best down the road to whatever it was, wherever it went

down to, and nobody foresaw collapse of the Internet and technology stocks." 3/24 Tr. at 308-309. According to the Debtor's testimony, Laidlaw owned a subsidiary that was working on a project called "Global Share," which was "a large factor in the valuation given to Laidlaw which at some point reached close to $1 billion." 3/24 Tr. at 307.

Pascal Wallet was asked on cross-examination:

> Q: And there was a substantial profit in the conversion when they were converted.
>
> A: Not anymore, because it was on paper only.
>
> Q: Right. At the time they were converted, there was a substantial profit.
>
> A: But it was profit on paper because I never got that money.
>
> Q: You never told anyone to sell the shares at that time either. Correct?
>
> A: You could not sell.
>
> Q: You never had them sold at any time. Is that correct?
>
> A: We wanted at a certain point, because according to what I knew, they were blocked. Afterward, when they were deblocked, when they were unblocked, they were totally worthless.

3/23 Tr. at 104-105. By "worthless," Plaintiffs explain that the stock dropped from over $20 per share to approximately $1.25 per share. Plaintiff's FFCL, p. 2-3. The Debtor testified that the stock restriction prevented unloading of the stock in the United States until after the price dropped, but that after the restriction was lifted: "It was still at the reasonable cost basis, you know, at one dollar something, considering there had been a split of three for two, so it would be like 166, a small loss, but it was no longer the 10, 15, 20 that they had seen." 3/24 Tr. at 313.

E. <u>Debtor's Interest in Maintenance of Laidlaw Stock Price</u>

Plaintiffs assert that it was in the Debtor's interest to maintain the share price of Laidlaw, and that conversion of the bonds to stock benefited the Debtor and Laidlaw. The Debtor testified, referring to Laidlaw's 1999 Form 10-K (Jt. Ex. 75), that between May 15, 1997 and April 7, 2000 he received 225,000 options of Laidlaw with an exercise price per share of $2.33.

If the stock price were to appreciate by 5%, the Debtor could potentially realize profit of $1,727,250, or a profit of 1,827,000 from a 10% appreciation. 3/23 Tr. at 131-133. During the same period, and at the same exercise price, Debtor had also received another 62,700 options, which would have realized profits of $479,655 and $509,124 based upon a stock price increase of 5% and 10% respectively. Debtor also testified that as of April 2000 he had realized a gain of $1,050,000 from the exercise of options. 3/23 Tr. at 135; Jt. Ex. 75, p. 32. Debtor's testimony was that of the 437,700 beneficial shares, only about 100,000 were actual share ownership and the rest were options. According to Laidlaw's 2000 Form 10-K (Jt. Ex. 76), Debtor received an additional 150,000 options in the following year.

Under the heading "Liquidity and Capital Reserves," at page 24 of Laidlaw's 1999 Form 10-K is the statement that:

> The creditworthiness of Laidlaw has improved substantially as a result of the conversion of $8 million of its 8% Convertible Notes into equity. An offer to exchange the 12% Senior Secured Euro-Notes into shares of common stock of Laidlaw yielded a strong response from the note holders who have agreed to exchange $1.9 million in principal indebtedness of the total $2.305 million for Laidlaw common stock.

Of course, a portion of the bonds converted represent the holdings of Walco, RBCW and WPC. The Debtor agreed that the conversion improved Laidlaw's balance sheet and benefited him in small part. 3/24 Tr. at 188. The Debtor did not agree that Laidlaw's increased creditworthiness "had a tendency to improve the stock price" because "the company's multiple is based on future earnings". 3/24 Tr. at 189.

F. <u>Failure to Disclose Conflicts of Interest</u>

Plaintiffs claim that the Debtor "never disclosed anything in writing directly to plaintiffs concerning defendant's ownership of Laidlaw shares and options." Plaintiff's FFCL, p. 4.

At the time of the Laidlaw Bonds purchase, Debtor may not have revealed that he was employed by Laidlaw. Debtor testified that "initially there was no need for a discussion, because when they purchased bonds, I didn't have any legal responsibilities that could create a conflict of any kind. At the time of the conversion, I had responsibilities, but there was no – the conversion was offered to all the bondholders and there was no conflict for me to offer the conversion." 3/24 Tr. at 324-325.

Pascal Wallet testified that possibly as early as October 1997 or as late as the beginning of 1998 he had "an idea that [Debtor] worked for Laidlaw." 1/12 Tr. at 28. Joint Exhibit 17 is an account statement from Laidlaw to Walco for the period between October 13, 1997 through November 28, 1997. The account executive listed is "Roger Bendelac, Laidlaw Equities." Pascal Wallet testified that he would have received this statement in Paris, and that he sent the money to make the first transaction, $100,000 of 12% Euro Bonds issued by Laidlaw Holdings. 1/12 Tr. at 28. Pascal Wallet was asked, "would it be fair to say that at some point in – around the time of this transaction, you learned of Roger Bendelac's relationship with Laidlaw" and replied: "It is very hard to tell. I never took real consciousness of this. When he would come to Paris for the road show, for the presentation, and when he would come with the papers with the letterhead of Laidlaw, he was there in that company with his brother." 1/12 Tr. 28-29. The Debtor's testimony is consistent: "I told them that I would be joining Laidlaw at some point that summer [that the Wallets were first buying bonds in Laidlaw]. Then I invited them to several lunches under the Laidlaw auspices in Paris on road shows where my title was largely – largely advertised on the description at the hotel where it was taking place. He had my business cards that said Laidlaw. He knew that my brother Daniel later on had an association with Laidlaw.

And he – from my recollection, Mr. Pascal Wallet even came to my Laidlaw office once." 3/24 Tr. at 323). Pascal Wallet denies visiting the Debtor at Laidlaw's offices.

The Debtor also testified that he disclosed his ownership of shares and options in Laidlaw to the Wallets:

> Q: Mr. Bendelac, during all the time you had dealing with Mr. Wallet or the Wallets and you were involved with WPC and Walco and RBCW, did you ever disclose to Mr. Wallet that you held shares and options in Laidlaw Global Corp.?
>
> A: Yes, I did.
>
> Q: When did you do that?
>
> A: Whenever I started owning shares, I informed them that I owned shares and informed them that I owned options. And once they became shareholders in Switzerland, they got the annual reports from the UBS that disclosed all this information.

3/24 Tr. at 181-182. The Debtor also testified to his belief that there was no conflict of interest during much of this period because the Wallets first invested in Laidlaw bonds before he joined Laidlaw. 3/24 Tr. at 184. Debtor also testified that he had discussed with the Wallets at some point that "on certain Laidlaw holdings, I couldn't make the call for them in terms of selling or not selling shares." 3/24 Tr. at 184.

It is significant that two separate agreements exist concerning the Debtor's relationship with Laidlaw. Joint Exhibit 95 purports to be "terms of understanding" dated July 19, 1999, drafted by Epsilog and addressed to members of RBCW LLC, including the Wallets. The terms of understanding were apparently adopted following a conference call between the members of RBCW LLC. The final term of understanding is:

> Epsilog Corporation shall not participate in the decision making regarding investments in Laidlaw Global Corporation whether in debtor or equity that might be agreed upon by members of RBCW LLC and shall be excluded from ownership in such securities to avoid any and all potential restrictions and conflicts of interest in conformity with previous agreements entered by Genersis Associates, Inc. with regard to the antecedent entity RBCW L.P.

Joint Exhibit 79 is a set of "WRITTEN RESOLUTIONS OF THE SOLE DIRECTOR OF THE COMPANY PASSED PURSUANT TO THE ARTICLES OF ASSOCIATION OF THE COMPANY" dated December 31, 1995. The sole director of WPC was Genersis, and the Debtor was the president of Genersis. Item 72 on page 16 of that document states:

> No person shall be disqualified from the office of Director . . . or prevented by such office from contracting with the Company, either as vendor, purchaser or otherwise, nor shall any such contract, or any contract or transaction entered into by or on behalf of the Company in which any Director . . . shall be in any way interested be or be liable to be avoided, nor shall any Director . . . so contracting or being so interested be liable to account to the company for any profit realised by any such contract or transaction by reason of such Director holding office or of the fiduciary relation thereby established. A Director . . . shall be at liberty to vote in respect of any contract or transaction in which he is so interested as aforesaid PROVIDED HOWEVER that the nature of the interest of any Director . . . in any such contract or transaction shall be disclosed by him . . . at or prior to its consideration and any vote thereon.

These documents, which the Plaintiffs presumably received and read, together with the foregoing evidence, suggests that the Plaintiffs were aware of the Debtor's relationship with Laidlaw and had no general objection to transactions in which the Debtor may have been interested.

G. No Portfolio Diversification; Alleged Gross Negligence and Recklessness

Plaintiffs claim they "wanted diversified investments." Plaintiffs' Proposed Findings of Fact and Conclusions of Law (hereafter, "Plaintiff's FFCL"), pg. 2. Pascal testified that he "wanted diversified investments, and in the first place, they should be sure and safe." 1/12 Tr. at 21-22.

From Pascal Wallet's testimony, it is clear that he was not only dissatisfied with the Debtor's investment decisions concerning Laidlaw but with other investment decisions that the Debtor made, referring to certain investments by Walco in Wah Fu and Mediumfour.com

between 2000 and 2002, the same period when the Debtor was purchasing Laidlaw shares: "The problem is, it was not only the Laidlaw shares that gave me concern, but the other companies like Wah Fu. For instance, he bought Hong Kong dollars. He took $50,000 to buy Hong Kong dollars without my authorization, and I didn't know what for." 1/12 Tr. at 56; Plaintiff's Ex. 65.

The Debtor testified that the Laidlaw purchases were consistent with the type of investments he had been making for at least six years with the Wallets: "They were consistent in the sense that they were speculative investment[s]. Mr. Pascal Wallet was at the time mostly counseling and getting high interest and looking into junk bonds, and we saw that those bonds at least were showing interest of a high level." 3/24 Tr. at 298.

> Q: "Was this the type of trading you were always – you were doing for – involving your relationship with the Wallets?"
>
> A: "Yes, because the Wallets did not need me to invest in chip stocks. They had like eight different brokerage accounts in France for that, they had other different relationships in the U.S., they had other relationships in Switzerland with a more conservative investment. This was, if you want, their speculative portion. That's why our relationship started at that level, because the first time I met them, they told me, you know, [w]e are wealthy people. We already have all type of advisers, investment, et cetera, but if you want to participate along with us and have some ideas as to something where we could speculate, then we would be willing to do so. That's why the first investment we had them involved in and I was myself involved in, because myself had been speculating all my life, was the Regency Future Fund, which was a very aggressive future fund trading.

3/24 Tr. at 318-319. Jt. Exhs. 159, 163 and 164. Pascal Wallet agreed that the $40,000 investment in Regency Funds was "truly speculative." 3/23 Tr. at 99-100. Debtor also offered evidence of Pascal Wallet's authorization on behalf of Walco of a private placement subscription agreement in Jinpan International Limited and Laidlaw Global Securities, Inc. at a price of $131,000 by subscription agreement dated November 13, 1997. The Jinpan investment was an investment of restricted stock similar to the Laidlaw shares. 3/23 Tr. at 114; Jt. Ex. 164.

H. Debtor Continued to Purchase Shares of Laidlaw

Plaintiffs claim that the Debtor caused WPC to make numerous unauthorized purchases of Laidlaw Global stock between March 2000 and October 2001, and that virtually the only thing WPC purchased in 2001 was Laidlaw stock. Plaintiff's FFCL, p. 3. Plaintiffs claim that when they learned of the "unauthorized" purchases of Laidlaw shares, Pascal Wallet told the Debtor to stop, but the Debtor repeatedly scheduled, and then canceled, meetings in which Debtor stated he would explain the situation. *Id*. Pascal Wallet claims that he spoke to the Debtor numerous times by telephone about the purchase of Laidlaw shares. 3/23 Tr. at 58. Eventually Pascal Wallet testified that he not only told him to stop purchasing Laidlaw shares but that "I wanted to meet with him to establish the basic situation, how it was, but it was impossible to meet with him." 3/23 Tr. at 59. Pascal Wallet refers to a letter dated May 28, 2001 (Jt. Ex. 82) asking for a statement of all of the assets "managed by Laidlaw" and reciting that the statement had already been requested several times.

The Debtor was asked if Pascal Wallet "approved every purchase of Laidlaw stock" in the WPC and Walco accounts. He replied: "My testimony is that he was cognizant of every purchase." 3/24 Tr. at 199-200.

Although Pascal Wallet testified (1/12 Tr. at 36-37 and referring to Plaintiff's Exhibit 53) that he didn't authorize purchases of Laidlaw stock on March 17, 28, 29 and 30, 2000, he also testified that he did not normally authorize every purchase. 1/12 Tr. at 37. Plaintiffs claim that the Debtor "cannot point to a single piece of paper that indicates that plaintiffs authorized this massive buying of Laidlaw shares" (Plaintiff's FFCL, p. 3), at numerous points in his testimony Pascal Wallet stated that he trusted the Debtor and that the Debtor had the discretionary and legal

authority to make investment decisions for WPC, Walco and RBCW. *See also* Amended Complaint, ¶7: "The Wallets have known and trusted Roger Bendelac for many years."

Plaintiffs presented evidence of various unauthorized purchases of Laidlaw shares for WPC and Walco in 2000 and 2001. Plaintiff's Ex. 53, 58, 72, 73 and 82; 1/12 Tr. at 60-62. However, Exhibits 72 and 73 are addressed to Walco in Paris, and this fact is consistent with Debtor's testimony that Pascal Wallet was cognizant of purchases, whether or not they were authorized in advance.

The Debtor acknowledged there was no written authorization for purchases of Laidlaw stock in 2001 and 2002 and did not deny that throughout 2001 WPC bought virtually nothing but Laidlaw shares so that WPC became entirely an investment in Laidlaw. 3/24 Tr. at 196-199. Debtor explained that due to margin requirements and the illiquidity of the Laidlaw shares, the liquid assets had to be sold on short notice to meet the margin requirements. 3/24 Tr. at 198. Plaintiffs' counsel examined the Debtor about this course of conduct:

> Q: And you consider that to be proper management of a client's account?
>
> A: It was not a question of management since there was an input from the customer there, from the shareholders of the entity.
>
> Q: And you're saying – it's undisputed: Numerous shares were purchased in Laidlaw in 2001 and 2002, both in WPC and Walco. Is that correct?
>
> A: Yes.
>
> Q: And in fact the Walco account had nearly all its value in Laidlaw stock. And you're saying – it's your testimony that all of these Laidlaw purchases, purchases of Laidlaw stock, were authorized by whom?
>
> A: I discussed them with Pascal Wallet, who is right here.
>
> * * *
>
> Q: You're saying that the order came from Pascal Wallet?
>
> A: No. I said it was discussed with Pascal Wallet. I wouldn't take upon my self to buy a stock – a stock in a company I was an executive of without discussing it with the customer.

3/24 Tr. at 198-199. Plaintiffs' allegations that the Debtor continued to buy Laidlaw shares without authorization were potentially the most troubling to the Court, but the potentially troubling conclusion – that the Debtor made these purchases of Laidlaw shares as Laidlaw's business outlook steadily declined, in order to prop up Laidlaw – was never substantiated. Plaintiffs did not attempt to establish a chronology that showed purchases of Laidlaw increased in an inverse correlation to Laidlaw's economic well-being. In other words, Plaintiffs failed to show that the purchase of Laidlaw shares in 2000 and 2001 were something radically different from the general investment scheme of WPC and Walco up to that point, which favored risky and speculative investments.

The Debtor testified credibly that although in hindsight, the "beginning of the end" for Laidlaw was in March 2000, as late as August 2001 there was still a feeling that the market and Laidlaw might recover. 3/24 Tr. at 309, 322.

I. When Laidlaw Collapsed, the Value of Plaintiffs' Portfolios Collapsed

As previously noted, the most serious deficiency in Plaintiffs' case was the failure to break down the damages for which the Debtor should be held liable, *i.e.*, the "debt" that should be declared non-dischargeable under Section 523(a)(4) due to Debtor's acts. The Plaintiffs never made an earnest attempt to go beyond the argument that Plaintiffs placed $1,242,000 for investment with the Debtor, and lost it. The problem with this reasoning is obvious. It ignores the overall performance of the market for similar investments over the same time period, and it fails to show that the Debtor's acts were the proximate cause of any of the investment losses.

The Debtor testified that Laidlaw's downfall was consistent with the fate of Internet stocks in general at that time. 3/24 Tr. at 310. The Debtor's cross examination of Pascal Wallet,

introducing his deposition testimony, elicited begrudging agreement that at least some of the losses were due to the overall downturn in the market:

> Q: Are you claiming those damages are due to Mr. Bendelac's actions, or are they due to the market conditions?
>
> A: In all honesty, both, but with a greater percentage incumbent on Mr. Bendelac because I have investments elsewhere that have resisted much better.

3/23 Tr. at 82-83. Pascal Wallet testified on cross examination that investments in Lucent Technologies also lost money. 3/23 Tr. at 85-87. Pascal Wallet blamed Bendelac for those losses, too, "because of the way that he had administered my portfolio because it was a portfolio that was not diversified." 3/23 Tr. at 85, lines 10-13.

Finally, the testimony revealed that even if the Laidlaw bonds had not been converted to shares, they probably would have been valueless. The Debtor testified that the only bonds that were reimbursed were the small amount of Euro bonds that were not converted, and that all other outstanding bonds are today worthless. 3/24 Tr. at 334-337. It was not clear from the testimony whether the Euro bonds were reimbursed based on their face value or at a discount. 3/24 Tr. at 339. This testimony suggests that Plaintiffs were not damaged by the conversion of Laidlaw bonds.

The Debtor also provided testimony, which was not rebutted, that even after the Laidlaw shares became unrestricted, they could have been sold at a "a small loss." 3/24 Tr. at 313.

LEGAL STANDARDS

A plaintiff carries the burden of proving by a preponderance of the evidence that a debt is excepted from discharge under Section 523(a). *Grogan v. Garner*, 498 U.S. 279, 286 (1991).

A. Debtor Was Not a Fiduciary For Purposes of Section 523(a)(4)

1. Necessity of the Existence of a Trust

The broad, general definition of fiduciary, involving confidence, trust and good faith, is not applicable in dischargeability proceedings under § 523(a)(4). Section 523(a)(4) applies only to express or technical trusts. Constructive or implied trusts, or any trust where the existence of the trust is created merely on the basis of wrongful conduct (a trust *ex maleficio*) do not create a fiduciary relationship. Put another away, the fiduciary relationship must exist prior to the act creating the debt; a trust relationship cannot be said to arise merely from the wrongful conduct itself." *In re Zoldan*, 226 B.R. 767, 772-773 (S.D.N.Y. 1998)(citations omitted). *See also In re Short*, 818 F.2d 693, 695 (9th Cir. 1987); *In re Kaczynski*, 188 B.R. 770, 773 (Bankr. D. N.J. 1995) (implied or constructive trusts and trusts *ex maleficio* are not deemed to impose fiduciary relationships under the Bankruptcy Code).

"Although the precise scope of the defalcation exception is a question of federal law, its application frequently turns upon obligations attendant to relationships governed by state law. For example, state law can be an important factor in determining whether someone acted in a fiduciary capacity under Section 523(a)(4)." *In re Hayes*, 183 F.3d 162, 166 (2d Cir. 1999). "A statutory fiduciary under state law is only considered a fiduciary for purposes of section 523 if the statute: (1) defines the trust *res*; (2) identifies the trustee's fund management duties and authority; and (3) imposes obligations on him prior to the alleged wrongdoing." *In re Librandi*, 183 B.R. 379, 383 (M.D. Pa. 1995). *See also In re Hemmeter*, 242 F.3d 1186, 1190 (9th Cir.

2001). Plaintiffs also do not allege that an express trust existed. The Court is not aware of any case holding a non-attorney liable for a defalcation under Section 523(a)(4) due to a conflict of interest, where no express or technical trust exists. Thus, in order for Plaintiffs' claim to be non-dischargeable under Section 523(a)(4), a technical trust must have existed between the parties.

2. Debtor Was Not an Investment Adviser

At trial, the parties agreed that Cayman Islands law applies to WPC, and that New York law applies to RBCW. Plaintiffs do not allege that the Debtor's conduct violated either Cayman Islands or New York law. Essentially Plaintiffs argue that a technical trust (*i.e.*, a trust established by law) exists under the Investment Advisers Act of 1940, 15 U.S.C. § 80b *et seq*. Plaintiffs' counsel stated at the beginning of the trial on March 23, 2004: "I'm not sure at the end of the day, I'm going to necessarily feel that, in order to prevail, that the plaintiffs need to rely on Cayman law or New York law issues of officers' duties." 3/23 Tr. at 11. The Court asked: "If New York law or Cayman law doesn't apply, then how do we know if there's a defalcation?" 3/23 Tr. at 12. Plaintiff's counsel responded:

> I'm glad you asked that, Your Honor, because, in fact, I was about to start with just a slight expansion, if you will, on the point that Your Honor raised at the beginning of the trial . . . and that is: What do the plaintiffs intend to prove and what's here.
>
> And something that had not been mentioned that I would now mention to Your Honor, both in response to your question and otherwise, is that we have here a situation where the defendant and the company that he was generally CEO, ultimately president, et cetera, et cetera, Laidlaw, various Laidlaw companies, were investment advisers under the Investment Advisers Act of 1940, and that act, as stated in [*SEC v. Moran*, 922 F.Supp. 867, 895-96 (S.D.N.Y. 1996)], "Section 206 of the Advisers Act establishes a statutory fiduciary duty for investment advisers to act for the benefit of their clients, requiring advisers to exercise the utmost good faith in dealing with clients to disclose all material facts and to employ reasonable care to avoid misleading clients,". So we have, Your Honor, a statutory fiduciary duty.
>
> Similarly, in [*S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963)], that case held that this same subchapter requires that a registered investment adviser's advice to his clients be disinterested.

> And indeed, Your Honor, that – the specific requirements and sections of the law were relied on in cases exactly on the issue we're dealing with now. That case is [*In re Peterson*, 96 B.R. 314 (Bankr. D. Colo. 1988)]. And that case held that the Investment Advisers Act imposes upon an investment adviser statutory obligations and duties which rise to the level of fiduciary responsibilities within the meaning of the dischargeability statute. And in that case the Court went on to decide that the particular investment adviser there would not be discharged of a debt owed to his client because it found that the investment adviser's recommendations seem to have been made with his own best interests in mind and not those of the client.
>
> So, Your Honor, that's where I believe – we believe that express statutory fiduciary duty and obligations arise. And that's why I responded as I did to Your Honor that I'm not sure that we necessarily need to be looking to New York law or Cayman law or whatever, Your Honor, [or] any other state law, to find the required fiduciary duty that would then enable a finding of defalcation to be made, Your Honor.

3/23 Tr. at 11-13. *In re Peterson*, 96 B.R. 314, 322-232 (Bankr. D. Colo. 1988), which was cited by Plaintiffs at trial, held that the Investment Advisers Act, when read with the rules and regulations promulgated under it, "sets forth the three prerequisite elements necessary for a statutorily created fiduciary relationship" under Section 523(a)(4) and cases such as *In re Librandi*, *supra*. *Peterson* reached this determination by citing to the prohibition in the Investment Advisers Act prescribing certain transactions by investment advisers, including "engaging in any act, practice or course of business that is fraudulent, deceptive or manipulative as defined by the regulations promulgated in 17 C.F.R. § 275.0-2 et seq." *Id.*; 15 U.S.C. § 80b-6. 17 C.F.R. § 275.204-2 requires investment advisers to keep accurate and current records; and 17 C.F.R. § 275.206(4)-2 states that it is a fraudulent, deceptive or manipulative act for any investment adviser in possession of client funds to take any action directly or indirectly unless the client's funds are deposited in a segregated bank account, the client is notified of the place

and manner in which the funds will be maintained, and separate detailed records of any withdrawals are maintained. *Id.* at 323.[5]

> Plaintiffs' proposed findings of fact and conclusions of law includes the assertion that:
>
> Defendant was in a fiduciary relationship with respect to his activities to plaintiffs' investments generally because defendant was an executive officer and director of a corporation (Laidlaw Global Securities) that was a registered investment adviser under the Investment Advisers Act of 1940 . . . and the President, chief operating officer, chief financial officer and secretary of that investment adviser's parent company (Laidlaw Global Corp.)

Plaintiff's FFCL, pg. 6, ¶3. Other than the Investment Advisers Act, Plaintiffs do not allege that the Debtor violated any Federal securities laws or any State securities laws, or any regulation or order issued under Federal or State securities laws. *See* 11 U.S.C. § 523(a)(19)(A). For the proposition that the Debtor was an investment adviser under the Investment Advisers Act, Plaintiffs reference Laidlaw Global Corporation's Form 10-KSB for 1999, 2000 and 2001 (Jt. Exhs. 75-77). Item 1, Part E. of the forms, captioned "Lines of Business," list four business areas: Traditional Trading and Brokerage Services, Global On-Line Trading and Investment

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[5] Because this Court finds that the Debtor in this case was not an investment adviser under the Investment Advisers Act of 1940 the issue in *In re Peterson*, whether the Investment Advisers Act creates a technical trust, is not reached. It bears noting, however, that another court in the District of Colorado, found *Peterson* persuasive and, finding no authority to the contrary held that "the Investment Advisers Act gives rise to a trust that imposes a fiduciary capacity as contemplated by section 523(a)(4)." *In re Mones*, 169 B.R. 246, 256 (Bankr. Dist. Col. 1994). In the course of the decision in *In re Mones*, that court observed in a footnote:

> The Supreme Court has held that there is no private cause of action for damages under section 80b-6 of the Act and that only a limited private remedy to void the investment adviser's contract exists under section 80b-15. *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 19-25, 100 S.Ct. 242, 246-50, 62 L.Ed.2d 146 (1979). However, the Court noted that "[w]here rescission is awarded, the rescinding party may of course have restitution of the consideration given under the contract, less any value conferred by the other party. . . . Restitution would not, however, include compensation for any diminution in the value of the rescinding party's investment alleged to have resulted from the adviser's action or inaction." 444 U.S. at 25 n. 14, 100 S.Ct. at 250 n. 14. *See Wachovia Bank & Trust v. National Student Marketing*, 650 F.2d 342, 355 (D.C.Cir.1980); *Fed. Sav. & Loan Ins. v. Shearson American Express*, 658 F.Supp. 1331, 1344 (D.Puerto Rico 1987). Therefore, even if the court finds that the defendant engaged in fraud or acts constituting defalcation in breach of a duty imposed by the Act, the only debt that would exist under the Act would be for the amount of the commissions. *See Peterson*, 96 B.R. at 322 n. 2.

Id. at 256, fn. 9 (alteration in original). Incidentally, Plaintiffs failed to provide any evidence as to the amount of commissions that the Debtor received.

Service, Investment Banking, and Asset Management and Investment Services. Three of the four paragraphs under "Asset Management and Investment Services" pertain to Laidlaw's ownership of H&R Acquisition Corp. "whose wholly owned subsidiary Howe & Rusling is primarily engaged in asset management and services." The final paragraph of the "Asset Management and Investment Services" section states:

> Laidlaw Global Securities: Laidlaw Global Securities is also a registered investment advisory firm, and such [sic], provides services including performance monitoring selection of third party investment managers, and discretionary asset management. The investment advisory services offered by Laidlaw Global Securities are tailored for a variety of clients, including individuals, pension and profit-sharing plans, trusts and estates, charitable organizations, corporations and other businesses.

Jt. Ex. 75, p. 11; Jt. Ex. 76, p. 11; Jt. Ex. 77, p. 9. The Debtor testified that although the Form 10-Ks stated Laidlaw Global Securities was a registered investment advisory firm it was in fact "only a broker/dealer." 3/23 Tr. at 120. Moreover, "Under the broker/dealer, there were some personnel that were registered under the Investment Act and I was not one of those person[s]. I didn't have the special license required for that, or the qualification. I was simply a registered broker with a Series 7 license." 3/23 Tr. at 121. "There was another subsidiary called Laidlaw Asset Management, Inc., which was an investment adviser under the '40 act, and it closed down at some point and I forget when it was closed." The Debtor testified that the statement in the 10-KSB forms were true: "There's nothing false about it. I just said I was not part of the investment advisory firm." 3/23 Tr. at 145. Debtor testified that in 2001 Laidlaw Global Securities may have been registered as an investment adviser with the Securities and Exchange Commission, but that it did not conduct business as an investment adviser:

> Q: "It was not doing any investment advising during 2001?"
>
> A: "No. We had sent all the investment advisory business to the other subsidiary called [Howe & Rusling]. And Laidlaw Global Securities might have kept its

> license but was strictly doing brokerage business because all the investment adviser had resigned by that time."

3/23 Tr. at 154-155. The Debtor was asked about the services he performed for Laidlaw:

> A: "I was a broker/dealer."
>
> Q: "You weren't providing any investment advice?"
>
> A: "Not as an investment adviser under the '40 Act; I was not."
>
> Q: "But you were providing investment advice in some other form or fashion?
>
> A: "No. I was simply a broker. And whenever I had investment discretionary responsibility it was within the context of being either a general partner of an entity or being an LLC member, which were not requiring any registration under the Investment Act."

3/23 Tr. at 154-155.

It should be emphasized that the Plaintiffs do not contend – and the Debtor has emphatically denied – that the Debtor is himself a registered investment adviser under the Investment Advisers Act. Plaintiffs allege that the Debtor mismanaged funds by investing them in Laidlaw, a company in which the Debtor had an interest. The fact that Laidlaw was registered under the Investment Advisers Act does not, in this Court's opinion, create the requisite trust under Section 523(a)(4) as between Plaintiffs and the Debtor. Plaintiffs' citations of S.*E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 84 S.Ct. 275 (1963) and *S.E.C. v. Moran*, 922 F.Supp. 867, 895-96 (S.D.N.Y. 1996) are not availing, because those decisions presuppose that the Debtor is a registered investment adviser. *See SEC v. Capital Gains Research Bureau*, 375 U.S. at 191-92 ("The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline as investment adviser-consciously or unconsciously-to render advice which was not disinterested.") (footnote omitted); *S.E.C. v. Moran*, 922 F.Supp. at 895-96 ("Section 206 of the Advisers Act establishes a statutory fiduciary duty for investment advisers to act for the benefit

of their clients, requiring advisers to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients.").

Plaintiffs also urge that "even if not duly registered," Debtor should still be considered an investment adviser within the meaning of the Investment Advisers Act because the Debtor "received compensation for managing plaintiffs' investments and plaintiffs relied upon defendant's investment advice." Plaintiff's FFCL, pg. 6, ¶3. Plaintiffs have provided no case where an unregistered person was deemed an investment adviser under the Investment Advisers Act and therefore a fiduciary within the meaning of Section 523(a)(4). *Abrahamson v. Fleschner*, 568 F.2d 862, 869-71 (2d Cir. 1977), which was not decided in the context of an objection to discharge in bankruptcy, held that two general partners were investment advisers under Section 202(a)(11)[6] of the Investment Advisers Act because they "received substantial compensation for managing the limited partners' investments" in the investment partnership of

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[6] The current version of that section states:

> "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but **does not include** (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956 [12 U.S.C.A. § 1841 et seq.] which is not an investment company, except that the term "investment adviser" includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) **any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor**; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934 [15 U.S.C.A. § 78c(a)(12)], as exempted securities for the purposes of that Act [15 U.S.C.A. § 78a et seq.]; or (F) **such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order**.

15 U.S.C. § 80b-2(a)(11) (emphasis added).

which they were all members, and were engaged in the business of advising others with respect to investments. Thus, Plaintiffs ask this Court not only to follow the *Peterson* case, but to go beyond *Peterson* by reading it together with *Abrahamson v. Fleschner* and hold that an unregistered investment adviser is a fiduciary within the meaning of Section 523(a).

Plaintiffs have not demonstrated either the necessary facts or the legal guidance that would persuade this Court that the Debtor should be considered an investment adviser for the purposes of the Investment Advisers Act. The Debtor testified that he did not act as an investment adviser in his capacity as an officer or director of Laidlaw, stating that he was "simply a broker." 3/23 Tr. at 154-155. The Debtor may have received substantial compensation from Laidlaw, but it was not shown that Debtor's compensation from Laidlaw was directly related to providing investment advice.

> Q: You weren't providing any investment advice?
>
> A: Not as an investment adviser under the '40 Act; I was not.
>
> Q: "But you were providing investment advice in some other form or fashion?
>
> A: No. I was simply a broker. And whenever I had investment discretionary responsibility it was within the context of being either a general partner of an entity or being an LLC member, which were not requiring any registration under the Investment Act.
>
> * * *
>
> Q: You were getting compensated for your services.
>
> A: No I was not.
>
> Q: No?
>
> A: I was getting only regular commissions. All the other compensation that was agreed upon or provided was compensation under the terms of a limited partnership agreement or under the terms of the contractual agreement for corporation as a director of an entity, but not as an investment adviser or as a co-investor."
>
> Q: What were you getting the compensation for? For what services?
>
> A: I was getting it – because I was a director, I would get compensation as a general partner, a representative of the general partner. It was the partnership

> agreement that provided for certain compensation. But none of them qualified under the Investment Act. . . .

3/23 Tr. at 154-156. The Debtor testified that he only received a full commission on one of the Laidlaw bond purchases by Walco, WPC and RBCW; for all other transactions involving Walco, WPC and RBCW he received either no commission or a nominal commission. *See* Pl. Ex. 148; 3/24 Tr. at 288-297.

- The Debtor was not employed by Laidlaw when WPC made the July 14, 1997 purchase of Laidlaw Holdings notes. 3/24 Tr. at 293.
- The Debtor recalled that WPC's October 15, 1997 bond purchase was a complicated matter that would have been compounded by a commission, and that it was "possible that I waived the commission for this." 3/24 Tr. at 296.
- Debtor received a full commission on Walco's November 28, 1997 purchase of $100,000 in Laidlaw 12% Euro Bonds. 3/24 Tr. at 289.
- For Walco's January 1, 1998 purchase of H&R bonds, the Debtor testified that he was the broker of record and received a "limited commission" of perhaps $50. 3/24 Tr. at 291.
- The Debtor got "some kind of brokerage commission" for Walco's September 30, 1998 purchase of $15,000 in Laidlaw bonds. 3/24 Tr. at 291-292.
- The Debtor did not recall receiving a commission for RBCW's September 29, 1998 purchase of Laidlaw Holdings bonds and "was prevented from getting a commission because I had a direct interest in that account." 3/24 Tr. at 296.
- The same was true of RBCW's December 31, 1998 purchase: "Because I was a participant in the transaction, I had to waive my right to a commission because I had to disclose my interest in [that account]." 3/24 Tr. at 297.
- The Debtor testified that he was the broker of record on Walco's December 31, 1998 bonds purchase and received a "minimum" commission. 3/24 Tr. at 292.

Lacking the support of specific and clear evidence, this Court is reluctant to deem the Debtor an "investment adviser," particularly in view of the exceptions in that definition, including for "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." 15 U.S.C. §80b-2(a)(11). Moreover, the Debtor did not manage RBCW and WPC directly but through Genersis and Epsilog. To the extent the Debtor had discretionary authority

to trade in Walco – even assuming this would qualify the Debtor as an investment adviser – Plaintiffs did not demonstrate whether and the extent to which the Debtor received compensation.[7]

3. In re Tomlinson

The facts of this case are remarkably similar to those in *In re Tomlinson*, 1999 WL 294879 (Bankr. N.D. Ill. May 10, 1999). In that case, the Debtor, Tomlinson, was sole director and owner of an investment advisory corporation, Elite Advisory Services, Inc. ("Elite"). Elite was registered under the Investment Advisers Act, but Tomlinson was not registered as an investment adviser. Tomlinson was also the sole director, president and treasurer of a separate management company, Champion Management ("Champion") (which Tomlinson also owned through a trust). Champion was a general partner of Dolphin Acquisition Partners, L.P. ("Dolphin"). As the court summarized: "Tomlinson was Elite, was Champion, was Dolphin." *Id.* at 9. The plaintiffs, a husband and wife, contacted Tomlinson who explained that he employed a "low-risk investment strategy." 1999 WL 294879 at *1. Tomlinson later wrote to plaintiffs on Champion letterhead, enclosing a private placement memorandum concerning Dolphin. In the letter, Tomlinson suggested that plaintiffs invest $50,000 in Dolphin. The Dolphin investment was a private placement and the stock was restricted. The parties agreed that Elite would be investment adviser for Dolphin and earn a 2.5% monthly fee on Dolphin's net portfolio value. In spite of plaintiffs' claims that they wanted safe investments, the Dolphin investment promised annual returns of between 25 and 27%. One of the plaintiffs testified that Tomlinson told him there would be no problem getting money out of Dolphin at any time. But plaintiff also testified

[7] Notwithstanding the language in *Abrahamson v. Fleschner, supra*, regarding "substantial compensation for managing," the actual words of the Investment Advisers Act refer to "engag[ing] in the business of advising others" for compensation. 15 U.S.C.A. § 80b-2(a)(11). The definition of "investment adviser" in that section does not include the word "manage."

that he had not carefully read the written warnings and risk factors contained in the private placement memorandum. Plaintiff's testimony was that he expected Tomlinson to read the prospectuses and similar documents for him, although he had never conveyed that expectation to Tomlinson. *Id.* at *4. As the value of Dolphin plummeted, plaintiffs asked to get out of the investment. There was testimony that Tomlinson allowed several other limited partners, including the trustee of the trust through which he owned Champion, to withdraw their Dolphin investments, but told plaintiffs he could not get them out right away. The court found: "At trial, the only explanation given by either side for Dolphin's losses was Tomlinson's testimony . . . that Dolphin's 1994 losses were attributable to a dramatic downturn in the stock market." *Id.* at *5.

The court also found that although the plaintiffs paid Elite for investment advice, Tomlinson was so closely identified with Elite that he was Elite for all intents and purposes. Nevertheless, although the court was conscious of the ruling in *In re Peterson*, *supra*, citing the case at page *17, it did not impute liability under the Investment Advisers Act to Tomlinson. The court ruled that Tomlinson's debt to plaintiffs was dischargeable, rejecting challenges under Section 523 (a)(2)(A)(for fraud), and Section 523(a)(4). Key to both counts was the finding that plaintiffs could not "repose absolute trust" in Tomlinson, because Tomlinson owed plaintiffs no fiduciary duty because "[t]he essence of a fiduciary relationship is that one party is dominated by the other." *Id.* at 14. The court found that the plaintiff was "not a naïve innocent" but "an experienced businessman who ought to know better than to dismiss such stern and forbidding warnings on the word of a man whom he had known barely six months and who stood to make substantial money from the success of the limited partnership." *Id.* at 13. Thus, the plaintiffs could not show that Tomlinson "gained influence or superiority over them" by any of several

factors such as (1) "expert knowledge" (either real or claimed) "the deployment of which the principal cannot monitor," (2) kinship, (3) age disparity, (4) health, (5) mental condition, (6) education, (7) business experience, or (8) the extent of the reliance. *Id.* at 14. In that case, plaintiffs were "not so young as to be considered a babe in the woods," did not allege poor health or an adverse mental condition. One of the plaintiffs had a college degree in business and completion of several business classes. Although Tomlinson had expert knowledge, plaintiffs were "not only able to check his deployment of it" but one of the plaintiffs "insisted on doing so regularly." *Id.* at 15. The court found that the plaintiffs were aware of the risks related to the Dolphin investment but chose to ignore the warnings and bury their head in the sand. *Id.* at 13.

In the case at bar, the Debtor was not a registered investment adviser. He managed investments of the Plaintiffs through entities that he controlled, Genersis and Epsilog. The Debtor recommended that the Plaintiffs invest in Laidlaw bonds. The Debtor eventually became chief operating officer. Later, the Laidlaw bonds were converted to restricted stock. Although the Plaintiffs expressed a desire for "sure and safe" investments, the history of the investments they authorized suggests otherwise. Like the plaintiffs in *Tomlinson*, the Plaintiffs, particularly Pascal Wallet, monitored investments closely and were aware of the investment risks, but cited their "total trust" of the Debtor and lack of knowledge when it suited them. As in *Tomlinson*, there is no disparity of expertise between the Debtor and the Plaintiffs. The Plaintiffs are sophisticated investors. It could not be seriously suggested that the Plaintiffs were "dominated" by the Debtor. The testimony did not reveal that the Plaintiffs were not able to monitor the Debtor. The Plaintiffs were not disadvantaged by kinship to the Debtor, or by age disparity, health or mental condition. No testimony indicated that the Debtor had education or business experience superior to Plaintiffs'.

B. A Defalcation Was Not Proven

Because the Debtor was not acting as a fiduciary for the purposes of Section 523(a)(4), the question of whether the Debtor committed an act that would constitute a "defalcation" while acting in that fiduciary capacity is not reached. Nevertheless, an analysis of the meaning of "defalcation" is appropriate.

Courts in this circuit have held that defalcation "requires at least some element of wrongdoing on the part of the debtor/fiduciary". *In re Zoldan*, 221 B.R. 79, 88 (Bankr. S.D.N.Y. 1988). "[M]ere negligence, without some element of intentional wrongdoing, breach of fiduciary duty or other identifiable misconduct, does not constitute 'defalcation' within the meaning of section 523(a)(4)." *In re Ellenbogen*, 218 B.R. 709, 714 (Bankr. S.D.N.Y. 1998) (finding no cases in which a court clearly denied a debtor's discharge for a defalcation for truly innocent or merely negligent conduct). Certainly, the meaning of "defalcation" must be defined in the context of the "well-established interpretational rule that exceptions from discharge are to be strictly construed so as to give maximum effect to the policy of the bankruptcy code to provide debtors with a 'fresh start'." *Kawaauhau v. Geiger (In re Geiger)*, 113 F.3d 848, 853 (8th Cir. 1997), *aff'd*, 523 U.S. 57 (1998).

> Section 523(a) of the Bankruptcy Code sets forth those circumstances under which dischargeability may be denied in respect of particular debts. Certain subsections of Section 523(a) deny dischargeability of debts arising from conduct of the debtor which was inherently wrongful, illicit or morally reprehensible. Subsections (2), (4) and (6) . . . are examples, and it is a prerequisite of each that the claim be predicated upon some demonstrably wrongful, illegal or morally reprehensible conduct by the debtor.

In re Hyman, 320 B.R. 493, 501 (Bankr. S.D.N.Y. 2005) (emphasis added). "The purpose of Section 523 was to remove from the debtor's capacity the ability to discharge certain debts arising from practices Congress deemed so pernicious that bankruptcy should not insulate the debtor from their payment. For our purposes, defalcation is 'willful neglect,' essentially a

standard of recklessness or at least gross negligence." *In re Zoldan*, 226 B.R. 767, 777-778 (S.D.N.Y. 1998).

For the reasons discussed at length above, Plaintiffs did not prove that any act of the Debtor constituted a defalcation. The Court has found that the Debtor was encouraged to pursue high-risk and speculative investments. Debtor's investments in Laidlaw were not a radical departure from that investment scheme. Although the Plaintiffs were aware of the Debtor's connection to Laidlaw, this fact did not initially affect Plaintiffs' trust in him. Pascal Wallet presented testimony, on one hand, that the Wallets trusted the Debtor and gave him discretionary authority, and on the other hand that many of the Debtor's transactions were unauthorized and that Pascal Wallet was unaware of them. The Court believes that the Debtor managed the investments of Walco, WPC and RBCW with Plaintiffs' approval, which was withdrawn only after the accounts suffered heavy losses.

C. No "Debt" Was Proven

Even if the Debtor had acted in a fiduciary capacity and had committed a defalcation, the Plaintiffs still did not show the essential element of damages. Only a "debt" related to a defalcation while acting in a fiduciary capacity is excepted from discharge in bankruptcy. Although Plaintiffs are unhappy that their investments in Walco and WPC are virtually worthless today, they failed to demonstrate at trial that the Debtor was ultimately responsible for this. There was no testimony that the Plaintiffs did not authorize the purchases of Laidlaw bonds (other than one purchase of $15,000). At the time the Laidlaw bonds were converted to shares, it appeared from all accounts to be a good deal. Eventually Laidlaw's shares dropped in value, but not in disproportion to the stocks of other companies in that sector at that time.

Conclusion

For the foregoing reasons, judgment shall be awarded to the Debtor, declaring that the debts in question are dischargeable. Debtor's counsel is hereby requested to promptly submit an order consistent with this decision.

Dated: Poughkeepsie, New York
September 1, 2005

/s/ Cecelia Morris
U.S.B.J.