

UNITED STATES BANKRUPTCY COURT
For the Southern District of Iowa

In the Matter of
BERNHARD G. WILTFANG and
B. BERNADINE WILTFANG,
d/b/a WILTFANG FARMS,

Case No. 86-146-C
Chapter 7

Debtors.

ORDER ON MOTION FOR PARTIAL RELIEF FROM STAY

On January 26, 1987, the motion for partial relief from stay filed December 1, 1987, by creditors Robert, Barbara, and Winifred Kline (hereinafter "Creditors"), and resistances thereto filed December 8, 1987, by creditor Douglas County Bank & Trust Co. (hereinafter "Bank"), and filed December 14, 1987, by Debtors came on for a hearing before this court in Des Moines, Iowa. John C. Conger appeared on behalf of Creditors, Robert C. Thomson appeared on behalf of Bank, and Wade R. Hauser, III and Elizabeth A. Nelson appeared on behalf of Debtors.

FACTUAL BACKGROUND

On January 21, 1986, Debtors filed a voluntary Chapter 7 bankruptcy petition with this court. At the time Debtors' petition was filed, Creditors had a lawsuit pending in the Iowa District Court for Jasper County, captioned Kline V. Beef Barons, et. al., Law No. 97-212, naming Debtors, Bank and others as defendants. Also pending in the same court were two other actions involving Debtors as defendants and

the Iske and Nearnmeyer families as plaintiffs. All three actions in large part involve allegations of fraud, particularly on the part of Debtors.

Since the filing of Debtors' Chapter 7 petition, several adversary proceedings have been commenced to determine their dischargeability, including: 1) Robert Kline, et al, v. Debtors, Adv. Pro. No. 86-0112, filed May 27, 1986; 2) Harlan Iske, et al, v. Debtors, Adv. Pro. No. 86-0113, filed May 23, 1986; 3) Carroll M. Nearnmeyer v. Debtors, Adv. Pro. No. 86-0114, filed May 23, 1986; and 4) Douglas County Bank & Trust Co. v. Debtors, Adv. Pro. No. 86-0115, filed May 27, 1986. Like the pending state court actions, these adversary proceedings also involve allegations of fraud on the part of Debtors. In fact, the specific allegations are almost identical to those in state court. Furthermore, except for Douglas County Bank & Trust Co. in Adv. Pro. No. 86-0115, the plaintiffs in all the state court and adversary proceeding actions are represented by the same counsel.

On April 14, 1986, in a hearing on a motion similar to the one in the case at bar, Judge Stageman denied a motion by counsel for the Klines to lift the automatic stay in order to proceed with the various state court actions against Debtors. In its ruling, the court noted that it had exclusive jurisdiction on the issue of fraud.

On January 5, 1987, the Judge of the Iowa District Court for Jasper County entered an order prohibiting further proceedings in the state court action until the bankruptcy matter was either disposed of by trial or the stay was lifted.

On December 1, 1987, Creditors filed a motion for partial relief from the stay in order to pursue their state court claims against Bank and other defendants but not against Debtors. They argued that the continuation of their Jasper County suit would not hinder, burden, delay or be inconsistent with Debtors' bankruptcy case.

On December 8, 1987, Bank filed a resistance and argued that since all state court and adversary proceeding actions involving Debtors were so closely related on the issue of fraud, the stay should not be lifted. In addition, Bank referred to Judge Stageman's April 14, 1986, ruling that fraud issues were under the exclusive jurisdiction of the bankruptcy court.

On December 14, 1987, Debtors also filed a resistance and argued that even though Creditors would not pursue the claims against them, Creditors would have to prove fraud by the Debtors in order to proceed to judgment against Bank. Therefore, Debtors would have to defend themselves in state court anyway, thus frustrating their fresh start and creating an inconsistency with Judge Stageman's prior ruling.

DISCUSSION

The issue in this case is whether Debtors' automatic stay also encompasses the Bank. As a general rule, the automatic stay provisions of 11 U.S.C. section 362(a) apply only to the bankrupt debtor and not to third party defendants or co-defendants. A. H. Robins Co., Inc. v. Piccinin, 788 F.2d 994, 999 (4th Cir. 1986); In re Metal Center, Inc., 31 B.R. 458, 462 (Bankr. D. Conn. 1983). However, some courts have looked beyond section 362 and determined stays as to debtor's nonbankrupt co-defendants are appropriate in "unusual circumstances." A. H. Robins, 788 F.2d at 999; see also In re Ms. Kipps, Inc., 34 B.R. 91 (Bankr. S.D. N.Y. 1983) (stay as to nondebtor necessary and appropriate where proof required to substantiate claims against debtors and co-defendant identical); Metal Center, 31 B.R. 458 (debtor's protection must be extended to enjoin litigation against others if result would be binding upon debtor's estate); Federal Life Ins. Co. (Mut.) v. First Financial Group of Texas, 3 B.R. 375 (Bankr. S.D. Tex. 1980) (where allegations against debtor and co-defendant inextricably interwoven, severance of defendants would not be conducive to judicial economy).

The A.H. Robins court noted that an "unusual situation" arises:

[W]hen there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will in effect be a judgment or finding against the debtor.

Id. at 999 (emphasis added).

In the case at bar, Creditors cannot proceed to a fraud judgment against Bank in state court unless they first prove fraud by the Debtors. Therefore, since the fraud issues are so inextricably interwoven, this case has developed into and now presents an "unusual situation" such that the court will extend Debtors' stay to the Bank.

Extending the stay is also necessary when considering the effect of a state court fraud finding against Debtors. Under a line of cases beginning with Brown v. Felsen, 442 U.S. 127 (1979), a state court fraud finding against Debtors would collaterally estop this court from making its own determination of fraud for purposes of dischargeability of Debtors. In Brown, the Court held that a bankruptcy court is not limited by res judicata to a review of a prior state court judgment and record when determining the dischargeability of a debt. Id. at 138-139. However, in dicta the Court noted collateral estoppel should be applied if the state court's decision on factual issues was based on standards identical to those used by the bankruptcy court in determining dischargeability. Id. at 139 n. 10.

Many courts have followed the Brown dicta and applied collateral estoppel when the state court standards were parallel to the bankruptcy court standards. In re LaCasse, 28 B.R. 214, 216 (Bankr. D. Minn. 1983); see In re Hauser, 72 B.R. 165, 166–167 (Bankr. D. Minn. 1986). This court agrees with the reasoning in those cases and follows their adoption of the Brown dicta.

As noted earlier, the case at bar has now developed to the point that Creditors' fraud issues in their state court action against Bank and in their bankruptcy adversary proceeding against Debtors are inextricably interwoven. Furthermore, the standard of proof for fraud in both the state court and the bankruptcy court is clear and convincing evidence. Thus, a state court finding of fraud against Debtors would collaterally estop them from defending themselves on the fraud issue in Creditors' dischargeability adversary proceeding. Therefore, in order to allow Debtors to defend against fraud in the adversary proceeding and to allow this court to independently make that fraud determination instead of being collaterally estopped from doing so by a state court finding of fraud, Debtors' stay must also encompass Bank.

CONCLUSION AND ORDER

WHEREFORE, based on the foregoing analysis, the court concludes that since the issue of fraud is so inextricably interwoven between Creditors' state court action against

Bank and their adversary proceeding against Debtors, and since a state court finding of fraud against Debtors would collaterally estop this court from independently determining the fraud issue in the adversary proceeding, Debtors' stay must also encompass the Bank.

THEREFORE, IT IS ORDERED, that Creditors' motion to partially lift stay is overruled.

DATED this 11th day of February, 1988.

RUSSELL J. HILL
US BANKRUPTCY JUDGE