BENCH MEMO: Smith, Receiver v. J.R. Paone, et al., v. Allstate Insurance Co.
Civil Action No. 87-780-A

ATTORNEYS

Plaintiff: Christopher Hopkins (Brown, Hopkins & Stambaugh, Alexandria)

Defendant: Gregory Murphy, David Schroeder (Murphy, McGettigan & West)

I. Introduction

This matter comes before you, Judge, on Plaintiff Ken Smith's motion to dismiss Count 2 of Defendant J.R. Paone's Counterclaim. Smith seeks to dismiss Count 2 for failure to allege fraud with particularity, as required by Rule 9(b), Fed. R. Civ. P. I will first give you some background, then discuss the merits of the motion.

II. Background

Plaintiff-Receiver Ken Smith is the court-appointed receiver for the assets of William Whitaker and WIC Investment Co. According the the Complaint, Whitaker invested over $200,000 into J.R. Paone Custom Limousine Service. Smith has asked or demanded that the investment be returned and has asked for an accounting of the monies received by J.R. Paone Limo. The Complaint also contains allegations that J.R. Paone breached its fiduciary duty towards the plaintiff. The defts. have filed an answer denying the allegations, and a counterclaim against Whitaker through Smith and added Allstate Insurance as a third-party defendant.

J.R. Paone Limo is a limo rental company in Atlantic City, N.J. Whitaker was the treasurer of J.R.Paone Co. J.R. Paone was the president; Michael Warley was the secretary of the corporation.

In its counterclaim against Smith/Whitaker, J. R. Paone alleges breach of contract and fraud against Whitaker and Allstate Insurance. This motion is about whether to dismiss Count 2 of the Counterclaim, alleging fraud. Smith as plaintiff has not to date filed any responsive pleading to the Counterclaim, but only this 12(b) motion to dismiss it.

III. Discussion of the Motion

Smith contends that Count 2 of the counterclaim fails to allege fraud with particularity, as required by Rule 9(b), Fed. R. Civ. P. In Virginia, the elements of actual fraud are: (1) false representation of a material fact; (2) a representation made knowingly with intent to mislead or defraud; (3) reliance by the party allegedly misled; and (4) damage to the party misled. Winn v. Aleda Constr'n Co., 227 Va. 304, 315 S.E.2d 193 (1984).

Smith contends that Paone has failed to allege sufficient facts to state his claim for fraud. Specifically, Smith contends that Paone has failed to make any allegation of (1) misrepresentations by Whitaker; (2) malice or intent to defraud or deceive; (3) or reliance by any of the Defendants. If anything, says Smith, the counterclaim makes out only a claim for breach of contract by Whitaker.

Here is a brief summary of the key allegations regarding fraud in the Counterclaim: Whitaker made at least $70,000 in loans to the corporation Paone for covering its start up and operating expenses, but these were not capital investments, but rather personal loans. (para. 5)

In July of 1985 Whitaker persuaded Paone and Warley to allow the corp. to enter into a purchase and security agreement with Allstate Financial Corp, a factor. (para. 6) This agreement provided for a steady cash flow to the corp. from Allstate, in return for the Corp's assignment of its accounts receivable to Allstate. (para. 7)

The agreement directed Allstate to make the payments to the Corporation, in the corporate name, and the first such payment was made that way. (para. 8) Thereafter, Whitaker wrote Allstate a letter telling it to send all payments directly to, in the name of, Whitaker. This action was unauthorized, and done without the knowledge or authority of Paone and Warley. (para. 9) Thereafter, Allstate started sending all money directly to Whitaker. Whitaker spent it for his personal use (converting it), occasionally making payments in cash to the Defendants in order to maintain a facade of fair dealing and fiduciary

responsibility. (paras. 10, 11) Allstate continued to make the payments to Whitaker for over a year. (para. 12)

Whitaker misused the funds for his personal benefit, failed in his duties as treasurer to pay the creditors of the corp., converted company property for his own use, and failed to pay income taxes for the corp.--all in derogation of his treasurer duties. (para. 13) Allstate and Whitaker by their acts of "material omissions and misrepresentations, as well as fraudulent concealment misused their fiduciary positions to deceive the defendants" as to the nature and truth of the distribution of funds under the agreement. (para. 18)

Allstate and Whitaker as fiduciaries to the corp. were under a duty to provide accurate information and to guard against the diverson of funds, without corporate authorization. (para. 19) Allstate and Whitaker were aware of the corporate bylaws requiring a 2/3 majority for all major decisions. (para. 20) The defendants Paone and Warley relied on the misrepresentations of Allstate and Whitaker (and their omissions) and have suffered great damage as a result. (paras. 21, 22)

Again, Smith (wrongly, I think) contends that the Counterclaim makes no allegations as to misrepresentations or omissions, as to intent to deceive, or as to reliance by defendants.

Defendants argue, on the other hand, that all of these have been plead with sufficient particularity. I think they are right. Reliance is expressly stated in paras. 21-22. (See Counterclaim, attached to Paone's Brief.) Also, Paras. 9, 11-13, 18-19 all indicate that Whitaker falsely represented to Paone that he was properly handling the company's funds. At least, they clearly imply such representation and omission. These same allegations, says Paone, indicate that Whitaker intended to deceive Paone, thus showing intent to defraud. Para. 18 specifically seems to allege this. These seem to sufficiently allege all essential elements of fraud, so as to put Smith on notice of the elements.

Paras. 21-22 also specifically allege that Paone suffered damage as a result.

As Paone properly points out, although Rule 9(b) does require that fraud be pleaded with particularity, it is clear that Rule 9(b) must be read together with the notice pleading requirement of Rule 8. Picture Lake Campgound, Inc. v. Holiday Inns, 497 F.Supp. 858 (E.D.Va. 1980) (Warriner, J.); Sweeney Co. v. Engineers-Constructors, Inc., 109 F.R.D. 358 (E.D.Va. 1986). (This last case is unavailable; I could not find the book--is it your decision, Judge, or that of Judge Warriner?)

Rule 8(e)(1) provides that "Each averment of a pleading shall be simple, concise, and direct. No technical forms of pleading or motions are required." Obviously, Rule 9(b) is something of an exception to the liberality of Rule 8, but it does not eviscerate the general purpose of Rule 8: to ensure that simple and clear pleadings will suffice, without having to allege detailed evidentiary facts. See 2A Moore, Federal Practice at 920-30 (2d Ed. 1979). It is clear that in interpreting fraud allegations, the requirements of the two Rules must be balanced. Picture Lake Campground, 497 F.Supp. at 866 (E.D.Va. 1980). As Judge Patrick Higginbotham wrote:

> if under the circumstances of the case it is apparent that even though plaintiff's pleadings are vague, the defendants do in fact have notice of the matters of which plaintiffs complain, a strict application of Rule 9(b) can serve no purpose.

In Re Commonwealth Oil/ Tesoro Petroleum Corp. Securities Litigation, 467 F.Supp. 227, 250-51 (W.D.Tex. 1979).

Finally, if you disagree that the fraud allegations are sufficiently specific, the defendants ask that you allow them to amend their Counterclaim, which they may do as a matter of right. Paone may amend the Counterclaim by right until Jan. 19, 1988 (20 days after filing) or until Smith files a responsive pleading thereto, under Rule 15(a). Smith's motion to dismiss is not a responsive pleading for purposes of Rule 15(a). Williams v. Wilkerson, 90 F.R.D. 168 (E.D.Va. 1981). I recommend that you DENY the motion to dismiss.

BENCH MEMO: Smith, Receiver v. J.R. Paone, et al., v. Allstate Financial Corp., CA No. 87-780-A.

ATTORNEYS

Plaintiff: Christopher Hopkins (Brown, Hopkins & Stambaugh)

Defendant: Gregory Murphy (Murphy, McGettigan & West)

I. Introduction

Judge, this matter comes before you on the plaintiff Smith's renewed motion to dismiss Count 2 of Paone's Counterclaim. Smith seeks to dismiss the Count 2 for its failure to allege fraud with sufficient particularity, as required by Rule 9(b), Fed. R. Civ. P. You first heard this motion to dismiss on Jan. 8 in Alexandria; you granted the deft's Paone leave to amend Count 2. They have amended Count 2 of their counterclaim, and Smith renews his former motion.

II. Background

Plaintiff Ken Smith is the court-appointed receiver for the assets of William Whitaker and WIC Investment Co. The Complaint states that Whitaker invested more than $200,000 into J.R. Paone Custom Limousine Service. Smith has demanded that the investment be returned and has asked for an accounting of the monies received by J.R. Paone Limo. The Complaint alleges that J.R. Paone breached its fiduciary duty to plaintiff. Paone has filed an answer denying the allegations, and a Counterclaim against Whitaker (via Smith) and Allstate Financial, as a third-party defendant.

J.R. Paone is a limo rental company from Atlantic City, N.J. Whitaker was the treasurer of the Corporation; J.R. Paone was its president, and Michael Warley was its secretary.

In its Counterclaim against Smith/Whitaker and Allstate, J.R. Paone alleges breach of contract and fraud. This motion is about whether to dismiss the fraud allegations in Count 2. Smith has not filed an answer to the Counterclaim but has renewed his motion under Rule 12(b) to dismiss Count 2.

III. The Allegations of Fraud

Smith contends that Count 2 of the Counterclaim fails to allege fraud with the particularity required by Rule 9(b). In Virginia, the elements of actual fraud are: (1) a false representation of a material fact; (2) a representation made knowingly with intent to mislead or defraud; (3) reliance by the party allegedly misled; (4) and damage to the party misled. Winn v. Aleda Construction Co., Inc., 227 Va. 304, 315 S.E.2d 193 (1984).

Specifically, Smith contends that in its Amended Count 2, Paone still fails to assert any allegations of particular representations or omissions made by Whitaker or Allstate. Smith argues that the alleged misrepresentations or omissions are all "unidentified," and that no specific facts are set out in support of the allegations. I disagree; I will here outline the allegations of the counterclaim which sufficently detail the statements and omissions.

Summary of the Allegations: From Jan. to May 1985, Whitaker made several loans of approx. $70,000 total to the Paone Corp., for covering its start-up and operating expenses. These were not capital investments but rather personal loans. (Para. 5) In July of 1985, Whitaker persuaded Paone and Warley to allow the Corp. to enter into a purchase and security agreement with Allstate Financial Corp. (para. 6). This agreement provided for a steady cash flow to the Corp. from Allstate, in return for the Corp's assignment of its accounts receivable to Allstate (para. 7).

The agreement specifically directed Allstate to make each payment to, and in the name of, J.R. Paone Corp. The first payment was made that way (para. 8). But thereafter, Whitaker wrote Allstate a letter requesting that all payments be made directly to Whitaker, in his name. This action was unauthorized and done without knowledge or consent of Paone and Warley (para. 9). Thus, Allstate started sending all money directly to Whitaker. Whitaker spent it for his personal use. As treasurer, his act of converting the Allstate funds "constitutes a fraudulent omission." (paras. 10-11) Having converted the money, Whitaker "occasionally made payments to

the defendants, in cash, in order to maintain a facade of fair dealing and fiduciary responsibility" (para. 12).

As para. 13 reads: "Whitaker knowingly and repeatedly made false statements to J. R. Paone and Mike Warley concerning the use of the diverted Allstate funds. Whitaker stated on several occasions that the money was being used to pay expenses and to make investments on behalf of the company. These statements were false and intended to deceive Paone and Warley in that Whitaker was actually using the money for his personal use" (emphasis supplied).

Allstate continued to make payment directly to Whitaker in violation of the agreement, from Aug. 1985 to Sept. 1986 (para. 14). By the misuse of corporate funds, "Whitaker and Allstate have defrauded the deft's to the extent of $350,000" (para. 16).

By their "material omissions and misrepresentations, as well as fraudulent concealment," Allstate and Whitaker have "misused their fiduciary positions to intentionally deceive the deft's/cross-pltf's as to the nature and truth of the distribution of the funds under the agreement" (para. 20). As fiduciaries to the deft's, Allstate and Whitaker "were under a duty to provide accurate information and to guard against the diversion of funds" without corporate authorization (para. 21). Allstate and Whitaker were both aware of the corporate bylaws requring a 2/3 majority vote for all major decisions (para. 22). "The deft's relied on the fraudulent misrepresentations and omissions of Allstate and Whitaker and have consequently suffered great economic damage to their business" (para. 23). (All emphasis supplied.) These misrepresentations were "knowing, wilful and wanton" and the deft's have actually lost over $300,000 in revenue and interest (para. 24).

IV. DISCUSSION

Paone argues on this basis that all of these elements have been plead with sufficient particularity. I agree. Reliance is expressly stated in paras. 23 - 24. Also, paras. 10, 13, 20, 23-24 all indicate that Whitaker falsely represented

to Paone, through statements and omissions, that Whitaker was properly handling the company's funds. Further, paras. 13, 20, 21 and 24 indicate that Whitaker acted with intent to deceive Paone; specifically, para. 13 states that the statments "were false and intended to deceive Paone and Warley." Para. 20 mentions "misused . . . to intentionally deceive." Finally, paras. 23-24 specifically allege that, in reliance on the false omissions and statements, the defts suffered substantial economic damage as a result. To my mind, Judge, these paragraphs of Count 2 all sufficiently allege the essential elements of actual fraud, so as to put Smith on notice of what the claim is alleging.

As the deft's properly observe, although Rule 9(b) does require that fraud be pleaded with particularity, it is clear that Rule 9(b) must be read together with the notice pleading requirement of Rule 8. Sweeney Co. of Md. v. Engineers-Constructors, Inc., 109 F.R.D. 358 (E.D.Va. 1986) (Warriner, J.); Picture Lake Campground, Inc. v. Holiday Inns, 497 F.Supp. 858 (E.D.Va. 1980)(Warriner, J.)

Rule 8(e)(1) provides that "each averment of a pleading shall be simple, concise and direct. No technical forms of pleading or motions are required." Obviously, Rule 9(b) is something of an exception to the liberal spirit of Rule 8, but it does not eviscerate the general purpose of Rule 8: to ensure that simple and clear pleadings will suffice, without allegations of detailed evidentiary facts. See 2A Moore, Federal Practice 920-30 (2d ed. 1979). In interpreting the fraud allegations, the requirements of the two Rules must be balanced. Sweeney, 109 F.R.D. at 360; Picture Lake Campground, 497 F.Supp. at 866. As Judge Patrick Higginbotham (now of the 5th Circuit) has written:

> if under the circumstances of the case it is apparent that even though plaintiff's pleadings are vague, the defendants do in fact have notice of the matters of which plaintiffs complain, a strict application of Rule 9(b) can serve no purpose.

In re Commonwealth Oil/Tesoro Petroleum Corp. Securities Litigation, 467 F.Supp. 227, 250-51 (W.D. Tex. 1979).

And Judge Warriner has held that the purposes of Rule 9(b), in requiring particular allegations, "are accomplished when a plaintiff alleges the 'time, place, and content of the false misrepresentation, the fact misrepresented, and what was gained or given up as a consequence of the fraud.'" Sweeney, 109 F.R.D. at 360 (quoting Moore's Federal Practice at 9.03 (1985)).

All of these elements are satisfied by the amended Count 2 of the Counterclaim. At worst, the deft's have alleged only the general time in which the misrepresentations were made; but they do say they were made repeatedly over the period of the year, from August 1985 to Sept. 1986. Everything else has been set forth in sufficient detail: the types of statements made or omissions not made; that they were false and fraudulent, and how they were; that they were made with intent to deceive; and that in reliance on these misrepresentations, the deft's suffered actual damage.

For these reasons, Judge, I recommend that you DENY the motion to dismiss. I believe you can do this effectively in a short order or an order with a short memorandum opinion. Or, alternatively, you could hold a conference call with counsel, explaining your reasons. Of course, if you deem it appropriate, you could always choose to issue a detailed opinion on the subject. Considering judicial economy (read: your law clerks already have plenty to do), even a motion of this great magnitude probably does not warrant a detailed opinion, much less a published opinion. But I leave this choice to you and await your decision.

DRW, 2/2/1988.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA

Alexandria Division

KEN McFARLANE SMITH, Receiver, Plaintiff, v. J. R. PAONE, et al., Defendants.	)	Civil Action No. 87-780-A

O R D E R

This matter comes before the Court on the plaintiff Smith's renewed motion to dismiss Count 2 of defendants' Counterclaim. Smith argues that Count 2 should be dismissed because it fails to allege fraud with the particularity required by Rule 9(b), Fed. R. Civ. P. The Court first heard this motion to dismiss on January 8, 1988. At that time, the Court granted the defendants leave to amend Count 2. Defendants have since amended Count 2 of their counterclaim, and plaintiff Smith now renews his former motion to dismiss. The parties have agreed to submit the motion on the pleadings without oral argument.

For the reasons stated herein, the Court now DENIES the plaintiff's motion to dismiss Count 2 of the counterclaim.

Count 2 of the defendants' counterclaim accuses Whitaker and third-party defendant Allstate Financial Corp. of committing a fraud on the defendants. In Virginia, the elements of actual fraud are as follows: (1) a false representation of a material

fact; (2) made intentionally and knowingly with intent to mislead or deceive; (3) reliance by the party misled; and (4) resulting damage to the party misled. Winn v. Aleda Construction Co. Inc., 227 Va. 304, 315 S.E.2d 193, 195 (1984).

Defendants argue that their amended Count 2 pleads all of these elements with sufficient particularity for purposes of Rule 9(b). This Court agrees. The first element is alleged by paragraphs 10, 13, 20, and 23-24 of the counterclaim. They assert that Whitaker falsely represented to the defendants, through statements and omissions, that Whitaker was properly handling the company's funds. The second element is sufficiently alleged in paras. 12, 13, 20, 21 and 24. These allege that Whitaker acted with intent to mislead and deceive the defendants; specifically, para. 13 claims that the statements "were false and intended to deceive Paone and Warley." Para. 20 speaks of fiduciary positions being "misused... to intentionally deceive the defendants."

The third element, reliance on the misrepresentations, is expressly alleged in paras. 23 and 24. Finally, the same paragraphs 23 and 24 specifically allege that the defendants suffered substantial economic damage as a result of such reliance.

As the defendants point out, Rule 9(b) must be read together with the notice pleading provisions of Rule 8. In interpreting fraud allegations, the requirements of the two Rules must be balanced. Sweeney Co. of Md. v. Engineers-Constructors, Inc., 109 F.R.D. 358, 360 (E.D.Va. 1986); Picture Lake Campground, Inc. v. Holiday Inns, 497 F.Supp. 858 (E.D.Va. 1980).

As Judge Warriner has held, the purposes of Rule 9(b) in requiring particularized allegations "are accomplished when a plaintiff alleges the 'time, place, and content of the false misrepresentation, the fact misrepresented, and what was gained or given up as a consequence of the fraud.'" Sweeney v. Engineers-Constructors, 109 F.R.D. at 360. The Court finds that Count 2 of the defendants' counterclaim has set forth all the essential allegations, and in sufficient detail. The plaintiff and the third-party defendant "do in fact have notice of the matters of which" defendants complain. See In re Commonwealth Oil/ Tesoro Petroleum Corp. Securities Litigation, 467 F.Supp. 227, 250-51 (W.D. Tex. 1979).

Therefore, the Court hereby DENIES the plaintiff's motion to dismiss Count 2 of the defendants' counterclaim.

It is so ORDERED.

Let the Clerk send a copy of this Order to all counsel of record.

Feb. 3, 1988
DATE

Richard L. Williams
RICHARD L. WILLIAMS,
United States District Judge