IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TEXAS
SHERMAN DIVISION

IN RE:	§	
	§	
RUSTY B. RUSSELL,	§	
	§	CASE NO. 02-46374
Debtor.	§	(Chapter 7)
______________________________	§	
PARKER TRAILER SALES, INC.,	§	
	§	
Plaintiff,	§	
	§	
v.	§	ADV. PROC. NO. 03-4070
	§	
RUSTY B. RUSSELL,	§	
	§	
Defendant.	§	

EOD
09/30/2005

MEMORANDUM OPINION[1]

Before the Court is the First Amended Complaint (the "Complaint") filed by Parker Trailer Sales, Inc. (the "Plaintiff" or "Parker Trailer") against Rusty B. Russell (the "Defendant" or "Debtor"). The Complaint seeks an order denying the Debtor a discharge pursuant to 11 U.S.C. §727(a)(2)(A) and (a)(5) or, alternatively, an order declaring the Debtor's obligations to the Plaintiff to be nondischargeable pursuant to 11 U.S.C. §523(a)(2)(A), (a)(4) or (a)(6). The matter was tried on April 1 and 12, 2004, at which time the parties presented argument and evidence. This Memorandum Opinion constitutes the Court's findings of fact and conclusions of law and disposes of all issues before the Court.

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[1]This Memorandum Opinion is not designated for publication and shall not be considered as precedent, except under the respective doctrines of claim preclusion, issue preclusion, and the law of the case, or as to other evidentiary doctrines applicable to the specific parties in this proceeding.

JURISDICTION

This Court has jurisdiction to consider the Complaint pursuant to 28 U.S.C. §§1334 and 157(a). The Court has the authority to enter a final judgment in this adversary proceeding since it constitutes a core proceeding as contemplated by 28 U.S.C. §157(b)(2)(A), (I), (J), and (O).

FACTUAL AND PROCEDURAL BACKGROUND

The Debtor is a high school graduate. He began working in the trailer sales industry in 1995. In February 1997, he began doing business for himself as Southwest Sales a/k/a Southwest Trailer Sales a/k/a Southwest Sales & Services. Additionally, in March 1997, the Debtor entered into a partnership with Robert Mulvaney called Southwest Trailer & Hitch.

Prior to entering into the partnership with Mr. Mulvany, the Debtor (as the authorized agent for Southwest Trailer Sales) executed a Consignment Agreement with Parker Trailer pursuant to which the Debtor would sell Parker Trailer's trailers. The terms of the Consignment Agreement required the Debtor to transmit the invoice price of the trailers to Parker Trailer immediately upon any sale. The Consignment Agreement further provided that Parker Trailer would deliver the titles to the trailers upon receipt of its portion of the sale proceeds.

Neither the Debtor nor Parker Trailer performed according to the letter of the Consignment Agreement. Parker Trailer gave the Debtor the titles for the trailers at the same time that it delivered the trailers to him for sale. The Debtor did not immediately remit

to Parker Trailer its portion of any sales proceeds. Rather, the Debtor deposited the proceeds into his general operating accounts and periodically sent Parker Trailer checks for its portion of the sales proceeds.

Roy Parker, the owner and president of Parker Trailer, testified that Parker Trailer delivered trailers to the Debtor once or twice a week, primarily during the spring and summer. In general, Parker Trailer's consignees transmitted sales proceeds to Parker Trailer on a weekly basis. Additionally, Parker Trailer conducted an inventory of its consignees' sales lots every few months. The consignees typically remitted the proceeds from any as-yet-unreported sales at the conclusion of the inventory.

In December 1999, the Debtor incorporated Southwest Trailer & Hitch. The Debtor was the president, sole officer and sole shareholder of Southwest Trailer & Hitch, Inc. ("Southwest Trailer, Inc.") at all relevant times. After incorporating his business, the Debtor continued to sell Parker Trailers' trailers pursuant to the Consignment Agreement.

The Debtor testified that he remitted approximately $600,000 to Parker Trailer during 2000 and between $400,000 - $500,000 during 2001. He began taking steps to grow his business and open a second sales lot during 2001. The Debtor hired several new employees and took out loans to buy equipment, including computers, software and several trucks. He also purchased a 60% interest in Diamond B Manufacturing ("Diamond B"), which manufactured truck accessories, in or around September 2001.

The Debtor deposited funds from his businesses into accounts for Southwest Trailer,

Inc. at Farmers & Merchants State Bank and Northstar Bank of Texas. The Debtor made all decisions about which creditors should be paid, and he wrote most of the checks for his businesses. His wife, Victoria Russell, and an employee, Jason Hicks, also had authority to write checks on the business accounts.

The Debtor's salary from Southwest Trailer, Inc. was his sole source of income.[2] The evidence at trial reflected that the Debtor occasionally made small payments (between $50 - $150) to his wife, Victoria Russell, his sister, Carmetta Whitfield, and his step-father, Roland Luginbyhl. The Debtor testified that Ms. Whitfield worked for a dry cleaning business and provided the Debtor and his employees with starched shirts. With regard to his step-father, the Debtor testified he paid him for occasional services to his businesses.

The Debtor's wife was occasionally paid $150 for running errands for the businesses. She was sometimes paid as much as $600 a month for running errands and for providing clerical support. Ms. Russell testified that she occasionally wrote checks from the business accounts to pay Ms. Whitfield for watching her children while she worked.

The Debtor wrote four checks to Parker Trailer during 2002 relating to the sale of an unspecified number of trailers: (1) $14,768.20 on or about January 24, 2002; (2) $13,030.60 on or about February 15, 2002; (3) $19,114.44 on or about March 5, 2002; and (4) $8,676.22 on or about March 27, 2002. Parker Trailer conducted a routine inventory of the Debtor's

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[2] The Debtor testified that Diamond B was not a profitable business and that he received no income from Diamond B. Other than his salary from Southwest Trailer, Inc., the only other source of income listed on the Debtor's Statement of Financial Affairs was $1,200 during 2001 and $1,200 during 2002 for "horse trading."

sales lot on March 25, 2002. The inventory revealed that twenty-six of the sixty-two trailers that should have been on the lot were missing.

There is no dispute that the Debtor sold the twenty-six trailers or that he failed to promptly remit the outstanding sales proceeds to Parker Trailer. There also is no dispute that the Debtor failed to satisfy the entire $63,908.20 obligation to Parker Trailer for the twenty-six trailers at the conclusion of Parker Trailer's inventory.

The Debtor testified at trial that he began experiencing an unanticipated downturn in his business in late 2001 or early 2002. He further testified that he had used the money from the sale of Parker Trailer's property in the ordinary course of his business to make payroll and to pay expenses, such as telephone bills and equipment lease payments.

The Debtor had never before defaulted under the Consignment Agreement, and he assured Mr. Parker that he would be paid. At Mr. Parker's request, the Debtor (as the authorized agent for Southwest Trailer, Inc.) entered into a Floorplan Agreement with Parker Trailer on April 1, 2002. The Floorplan Agreement required the Debtor to provide an accounting to Parker Trailer twice a month, accompanied by payment in full of all amounts due Parker Trailer.

After entering into the Floorplan Agreement, the Debtor continued to sell Parker Trailer's trailers and to deposit the proceeds into the general operating accounts for Southwest Trailer, Inc. The Debtor, however, failed to make any payments to Parker Trailer. Another inventory by Parker Trailer on April 25, 2002, revealed that only six of the sixty-

two trailers Parker Trailer had consigned to the Debtor remained on the Debtor's sales lot. At the conclusion of the inventory, the Debtor was unable to satisfy the $64,513.10 obligation to Parker Trailer for the additional thirty trailers sold after Parker Trailer's previous inventory.

On May 24, 2002, Parker Trailer filed a complaint against the Debtor in Texas state court. The Debtor failed to appear for trial on August 6, 2002. Accordingly, on October 7, 2002, the District Court in Titus County, Texas, entered a default judgment in favor of Parker Trailer and against the Debtor in the amount of $121,956.05, plus pre-judgment interest in the amount of $2,472.53, plus attorneys' fees of $12,750.00 and post-judgment interest of 10% per annum.

Parker Trailer deposed the Debtor on September 5, 2002, regarding his assets. The Debtor did not dispute his debt to Parker Trailer and expressed a desire to repay that debt. The Debtor's business, however, remained slow. The Debtor also testified that he was having personal problems with the Internal Revenue Service.

In November 2002, the Debtor's mother and step-father borrowed $100,000, secured by their home, to help the Debtor with his business obligations. They transferred the $100,000 to the Debtor in several installments of $20,000, and the Debtor promised to make (and did make) the monthly mortgage payments for his parents from his personal checking account. Additionally, the Debtor's step-father loaned the Debtor approximately $40,000. Both the Debtor's mother and his step-father testified that the Debtor mentioned his stock

in his businesses in his conversations with them regarding the advances, but they could not recall any details. The Debtor testified that he removed the stock for Southwest Trailer, Inc. from a corporate binder and placed it in an envelop for delivery to his parents.

It was clear to the Court from the Debtor's testimony at trial that the Debtor did not understand a "stock pledge," in the legal sense. It was equally clear that the Debtor did not understand the legal requirements for effectively pledging an interest in an incorporated business. The Debtor also did not distinguish between his personal obligations to his parents and an obligation of his businesses to his parents for repayment of the loans.

The Debtor testified, credibly, that he used the money he received from his parents to buy trailers, truck accessories, and to pay business expenses. The Debtor also testified, credibly, that he intended to continue to run the businesses in order to protect his parents' investment and to repay them.

As part of its collection efforts, Parker Trailer obtained an Order for Turnover for the Debtor's stock certificates in Southwest Trailer, Inc. and Diamond B, as well as any funds in the bank accounts for any of his businesses. On Monday, December 9, 2002, Parker Trailer sent a constable to the Debtor's sales lot in Lewisville, Texas. The Debtor testified that he first learned of the judgment against him at this time. He called his trial attorney, Sharon Smith, who referred him to another attorney.

The constable asked the Debtor for the stock in his businesses and for any monies in the bank accounts for his businesses. The Debtor told the constable that he had already

written checks against all the funds in his bank accounts and that he did not have any unencumbered funds in the accounts. With regard to the stock, the constable testified, credibly, that the Debtor first told him that the stock certificates were in the possession of his attorney. After the constable informed the Debtor that he could turn over the stock by signing a stock power form, the Debtor told the constable that he had transferred his interest in Southwest Trailer, Inc. to his step-father (Roland Luginbyhl) and his mother (Bertila Russell Luginbyhl).

Sharon Smith, the Debtor's attorney in the state court action, had possession of the Debtor's stock certificates in Diamond B at the time of trial in the present case. However, with regard to the Debtor's stock certificates in Southwest Trailer, Inc., the Debtor testified that he had discovered the certificates in a box in his home in May or June 2003.

Approximately one day after the constable's visit, on December 10, 2002, the Debtor filed a petition for relief under Chapter 7 of the Bankruptcy Code. He filed his bankruptcy schedules on January 16, 2003. The Debtor listed an interest in Southwest Trailer, Inc. and a 60% interest in Diamond B in his Schedule B (Personal Property). However, he listed little or no value for the businesses, and he claimed his interest in the businesses as exempt property in his Schedule C (Exempt Property).[3]

The Debtor also filed his Statement of Financial Affairs on January 13, 2003. In response to Question No. 10, which asked the Debtor to disclose any property transferred

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[3] The chapter 7 trustee objected to the Debtor's exemption of his business interests on February 26, 2003 [Doc. No. 18]. The Chapter 7 trustee withdrew her objection on April 25, 2003 [Doc. No. 41].

outside the ordinary course of business within one year of the Petition Date, the Debtor failed to disclose any transfer of his ownership interest in Southwest Trailer, Inc. or Diamond B to his parents. However, the Debtor listed his parents and Ms. Smith as creditors of Diamond B as well as personal creditors in his Schedule B (Personal Property) and Schedule F (Creditors Holding Unsecured Nonpriority Claims).

In response to Question No. 1 in his Statement of Financial Affairs, the Debtor estimated his gross income was $90,000 for 2001 and 2002. He testified at trial, however, that his gross income for 2001 and 2002 was approximately $41,000 for each year.

The Debtor testified that he did not believe he owned Southwest Trailer, Inc. when he filed for bankruptcy, but that he believed he had an interest in the company because he was still running it. He ultimately ceased doing business as Southwest Trailer, Inc., and "walked away" in or around August 2003. By that time, his operating accounts had been garnished by a secured creditor, his suppliers were demanding that he pay cash on delivery, and various secured creditors had repossessed most or all of their collateral.

In October 2003, Morningstar of Texas ("Morningstar") began selling trailers at the Debtor's former sales lot. Richard Smithey, the manager for Morningstar, testified that a few desks and phones had been left behind in the office. Several items of equipment owned by a company called Big Tex also had been left behind on the lot, and Morningstar purchased the equipment directly from Big Tex.

The Debtor began working for Big Tex Trailers ("Big Tex"), which is one of Parker

Trailer's competitors, approximately one week before trial. Prior to bankruptcy, the Debtor sold trailers on consignment for Big Tex. Similar to his dealings with Parker Trailer, the Debtor made payments to Big Tex from Southwest Trailer, Inc.'s operating accounts.

DISCUSSION

As a preliminary matter, the Debtor raises the affirmative defense of *res judicata* in his answer to the Complaint. The Debtor points out that the state court judgment contained no findings of fraud, breach of fiduciary duty or any finding that would indicate a nondischargeable debt. The Debtor impliedly argues that the absence of such findings precludes Parker Trailer from bringing its §523 and §727 claims.

It is well established that a party may invoke issue preclusion regarding a previously litigated matter in a dischargeability context in order to minimize additional litigation in bankruptcy court. *See Grogan v. Garner*, 498 U.S. 279, 284-85 (1991). However, issue preclusion bars this Court from reviewing dischargeability issues only in limited circumstances: "[c]ollateral estoppel applies in bankruptcy cases only if, *inter alia*, the first court has made specific, subordinate factual findings on the identical issue in question." *Id.* In this case, Parker Trailer's state court complaint did not plead fraud or breach of fiduciary duty, and the state court had no occasion to rule on such issues. Except for the existence, amount and validity of Parker Trailer's claim (which the Debtor does not dispute), the Debtor has failed to establish that the state court made any findings or conclusions that would preclude this Court from determining the discharge issues under §523 and §727 of the

Bankruptcy Code.

With regard to claim preclusion, in order for a judgment to serve as a bar to a subsequent action, four conditions must be met: "the parties must be identical in both suits, the prior judgment must have been rendered by a court of competent jurisdiction, there must have been a final judgment on the merits, and the same cause of action must be involved in both cases." *Nilsen v. City of Moss Point*, 701 F.2d 556, 559-60 (5th Cir.1983) (en banc) (quoting *Kemp v. Birmingham News Co.,* 608 F.2d 1049, 1052 (5th Cir.1979)). In this case, however, the state court did not hear Parker Trailer's dischargeability claims. Indeed, state courts do not have jurisdiction to adjudicate §523 or §727 claims. *See Brown v. Felsen,* 442 U.S. 127, 136 (1979) (preserving the exclusive jurisdiction of the bankruptcy court to determine dischargeability). Because §523 and §727 claims cannot be heard by a state court, the doctrine of claim preclusion does not and cannot bar the claims before this Court. *See id.*; *see also, e.g., Fielder v. King (Matter of King)*, 103 F.3d 17, 19 (5th Cir. 1997) (citing *Brown v. Felsen*).

For the foregoing reasons, the Court concludes that the Debtor has failed to establish an affirmative defense based on issue or claim preclusion.

A. Section 727 Causes of Action

Section 727 of the Bankruptcy Code provides that the Court must grant a discharge to a chapter 7 debtor unless one or more of the specific grounds for denial of a discharge listed in paragraphs (1) through (10) of § 727(a) is proven to exist. The provisions denying

a discharge to a debtor are generally construed liberally in favor of the debtor and strictly against the creditor. *See Friendly Fin. Discount Corp. v. Jones (In re Jones)*, 490 F.2d 452 (5th Cir. 1974). Further, under Federal Rule of Bankruptcy Procedure 4005, the burden of proof is on the party objecting to a debtor's discharge.

1. Section 727(a)(2)(A)

In this case, Parker Trailer argues that the Debtor's discharge should be denied pursuant to §727(a)(2)(A). Section 727(a)(2) is intended to prevent the discharge of a debtor who attempts to avoid payment to creditors by concealing or otherwise disposing of assets. Section 727(a)(2)(A) provides in pertinent part:

> (a) The court shall grant the debtor a discharge, unless–
>
> (2) the debtor, with intent to hinder, delay, or defraud a creditor . . . has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed–
>
> (A) property of the debtor, within one year before the date of the filing of the petition[.]

To sustain an objection under §727(a)(2)(A), the creditor must demonstrate four elements: (1) a transfer or concealment of property; (2) belonging to the debtor; (3) within one year of the filing of the petition; (4) with the intent to hinder, delay or defraud a creditor or officer of the bankruptcy estate. *See, e.g., Pavy v. Chastant (In re Chastant)*, 873 F.2d 89, 90 (5th Cir. 1989); *Cadle Co. v. Pratt (In re Pratt)*, 411 F.3d 561 (5th Cir. 2005). The intent to defraud must be actual, not constructive. *See In re Chastant*, 873 F.2d at 91. Nevertheless, a finding of actual intent may be based on circumstantial evidence or on inferences drawn

from a course of conduct.[4]

(a) Transfer of Property

The Debtor in this case admitted that the pledge of his interest in his businesses to his parents was not "papered." He also testified that he had not actually delivered the stock certificates for Diamond B or Southwest Trailer, Inc. to his parents. Under these circumstances, no stock transfer occurred, and Parker Trailer's claim under §727(a)(2)(A) must be denied to the extent it is based on a transfer of the Debtor's interest in Southwest Trailer, Inc. or Diamond B. *See* TEX. BUS. COMM. CODE § 8.301, *et seq*. (regulating the transfer of certificate securities).

(b) Concealment of Property

Parker Trailer also advances the argument that the Debtor's discharge should be denied because he concealed his interest in Southwest Trailer, Inc. and Diamond B from the constable. A "concealment" of property constituting grounds for denial of discharge includes preventing discovery, fraudulently transferring, or withholding knowledge or information required by law to be made known. *See Partners v. Womble (In re Womble)*,

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[4]In *In re Chastant*, the Fifth Circuit listed the following factors that tend to show actual intent to defraud:

> (1) the lack or inadequacy of consideration; (2) the family, friendship or close associate relationship between the parties; (3) the retention of possession, benefit or use of the property in question; (4) the financial condition of the party sought to be charged both before and after the transaction in question; (5) the existence or cumulative effect of the pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors; and (6) the general chronology of the events and transactions under inquiry.

Id. Furthermore, there is a presumption of fraudulent intent when a debtor transfers property to relatives. *Id.*

289 B.R. 836, 845 (Bankr. N.D. Tex. 2003) (citations omitted). The concealment should involve a secreting of assets in the context of the bankruptcy proceeding – that is, it should involve the hiding of assets from the reach of creditors for the purpose of secretly exempting a portion of the estate which would otherwise be payable to creditors through the bankruptcy proceeding. *See Miles Employee Fed. Credit Union v. Griffin*, 22 B.R. 821, 826 (Bankr. S.D. Ohio 1982); *see also In re MacDonald,* 114 B.R. 326, 334 (D. Mass. 1990) (collecting cases). As the Fifth Circuit explained in *In re Chastant*, "[t]he specific purpose of §727(a)(2)(A) is to deny a discharge to those debtors who, intending to defraud, transfer property which would have become property of the bankrupt estate." *In re Chastant*, 873 F2d at 90 (citation omitted).

In support of its concealment claim, Parker Trailer asserts that the Debtor "fabricated" a story that he had transferred his interest in Southwest Trailer, Inc. and Diamond B to his parents in order to hinder Parker Trailer's collection efforts. The Court, however, found the testimony of the Debtor and his parents regarding the Debtor's oral pledge of his interest in his businesses to his parents to be credible. Further, Parker Trailer failed to establish that any concealment by the Debtor of his interest in Southwest Trailer, Inc. or Diamond B impacted the bankruptcy estate – the Debtor included his interest in his businesses in his bankruptcy schedules, and there was no argument that the Debtor's disclosures were inadequate.[5] Parker Trailer likewise failed to establish that the Debtor's

[5] As discussed *supra*, the Debtor listed his interest in Southwest Trailer, Inc. and Diamond B as exempt property in his bankruptcy schedules. The Chapter 13 trustee initially objected to the Debtor's exemptions, but subsequently withdrew the objection. Thus, the Debtor successfully withdrew his interest in the businesses from

interest in Southwest Trailer, Inc. and Diamond B had any substantial value to creditors.

(c) Intent to Hinder, Delay or Defraud

To the extent the Debtor can be held to have "concealed" his interest in Southwest Trailer Inc. or Diamond B within the meaning of §727(a)(2)(A), Parker Trailer asserts that the Debtor did so with the intent to hinder, delay or defraud his creditors. The concepts of "intent" and "hinder or delay" are somewhat nuanced in this context. Several courts have construed the statutory phrase "hinder or delay" to mean that the debtor must have an actual intent to significantly impair a creditor's collection efforts. *See First Leasing Co. v. McGalliard (In re McGalliard)*, 183 B.R. 726, 732 (Bankr. M.D.N.C. 1995) (interpreting "hinder or delay" to mean "substantially and materially hinder or delay"); *American Sav. & Loan Ass'n v. Weber (In re Weber),* 99 B.R. 1001, 1017 (Bankr. D. Utah 1989) (same). Given the Fifth Circuit's imperative toward liberal construction, §727(a)(2) should not be construed to define "intent" broadly. Rather, §727(a)(2) should be read to make blameworthy only such actions as are actually intended to substantially hinder or delay a creditor's collection efforts. *See In re Pratt,* 411 F.3d at 567 (no error in bankruptcy court's conclusion that debtor had not intended a substantial deprivation of property to the estate).

Here, the stock certificates for Diamond B were, in fact, in the possession of Ms. Smith when the constable attempted to enforce the state court's turnover order. The Debtor filed for bankruptcy immediately after the constable's visit to his place of business, and he

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the bankruptcy estate. *See Owen v. Owen*, 500 U.S. 305, 308 (1991); 11 U.S.C. §522(l); FED. R. BANKR. P. 4003.

included all of his business interests in his bankruptcy schedules. Those businesses had little, if any, value, and he ultimately exempted his interest in his businesses from the bankruptcy estate.

As in *Robertson v. Dennis, et al. (In re Dennis)*, 330 F.3d 696, 702 (5th Cir. 2003), "the record reveals no sinister or calculating pattern of transactions." The Debtor's businesses were failing at the time his parents provided him a much needed cash infusion of $140,000. The Debtor hoped to continue to run his businesses – which had few, if any, unencumbered assets – in order to repay his parents. Having observed the Debtor at trial and considered his testimony, the Court finds that the Debtor intended to pledge his stock to his parents but did not understand the legal requirements for doing so. The Court further finds that he did not understand he had not legally effectuated the transfer of his stock in Southwest Trailer, Inc. when he spoke to the constable. Under these circumstances, the Court cannot infer fraudulent intent from an attempt by the Debtor to transfer his interest in Diamond B or Southwest Trailer, Inc. to his parents. *See Gullickson v. Brown (In re Brown)*, 108 F.3d 1290 (10th Cir. 1997) (holding that transfers made by debtors in an attempt to keep their business alive and satisfy creditors are not fraudulent); *Equitable Bank v. Miller (In re Miller*), 39 F.3d 301 (11th Cir. 1994) (same).

For the foregoing reasons, the Court concludes that Parker Trailer has failed to sustain its burden regarding its claim that the Debtor's discharge should be denied pursuant to §727(a)(2)(A).

2. Section 727(a)(5)

Parker Trailer also seeks to bar the Debtor's discharge pursuant to §727(a)(5). Section 727(a)(5) states that a debtor will be denied a discharge when "the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor's liabilities." The initial burden of going forward with evidence is on the objector, who must introduce more than merely an allegation that the debtor has failed to explain losses. Once the objector has introduced some evidence of the disappearance of substantial assets or of unusual transactions, the debtor must satisfactorily explain what happened. *First Texas Sav. Ass'n v. Reed (In re Reed)*, 700 F.2d 986, 992-993 (5th Cir. 1983).

A satisfactory explanation has not been definitively defined, but the debtor must explain the losses or deficiencies in such manner as to convince the court of good faith and businesslike conduct. Lack of wisdom in the debtor's expenditures, by itself, is not grounds for denial of a discharge. *Great Am. Ins. Co. v. Nye (In re Nye)*, 65 B.R. 759 (Bankr. E.D.N.C. 1986) (explanation need not be meritorious to be satisfactory). However, an explanation that is based primarily upon an estimate of the debtor founded upon nothing by way of books, records or otherwise has been held unsatisfactory. *In re Reed*, 700 F.2d at 993 (debtor's explanation that almost $20,000 was consumed by undocumented business and household expenses and gambling debts was unsatisfactory). More is required of the debtor in the way of explanation than mere generalities. *Casa Inv. Co. v. Brenes (In re Brenes)*, 261 B.R. 322 (Bankr. D. Conn. 2001) (debtor's testimony and records submitted showed that

much of the "loss of assets" was due to different valuations resulting from purpose of valuations and from substantial depreciation in value of some assets); *Martin Marietta Materials Southwest, Inc. v. Lee (In re Lee)*, 309 B.R. 468 (Bankr. W.D. Tex. 2004) (finding debtor's explanation sufficient).

Here, Parker Trailer complains that the Debtor failed to account for the loss of funds from his businesses. However, the Debtor testified that he put all sales proceeds as well as the money he received from his parents into his businesses' operating accounts. The record contains copies of checks from the operating accounts for Southwest Trailer, Inc. reflecting how the funds were spent. The Court finds credible the Debtor's testimony (which was supported by the bank records introduced at trial) that he was experiencing a decline in his business and used the proceeds from the sale of Parker Trailer's property to pay legitimate business expenses.

For the foregoing reasons, the Court concludes that Parker Trailer has not sustained its burden on a claim relating to the failure to explain a loss of assets under §727(a)(5).

B. Section 523 Causes of Action

The standard of proof for allegations under §523, like that of allegations brought under §727, is by a preponderance of the evidence. *Grogan v. Garner*, 498 U.S. 279, 286 (1991). "Intertwined with this burden is the basic principle of bankruptcy that exceptions to discharge must be strictly construed against a creditor and liberally construed in favor of a debtor so that the debtor may be afforded a fresh start." *Hudson v. Raggio & Raggio, Inc. (In re Hudson)*, 107 F.3d 355, 356 (5th Cir. 1997). Thus, without satisfactory proof of each

element of the cause of action, judgment must be entered for the debtor.

1. Section 523(a)(2)(A)

Parker Trailer asserts that the Debtor falsely represented in the Consignment and Floorplan Agreements that he would immediately remit the proceeds of the sale of Parker Trailer's property to Parker Trailer. Thus, Parker Trailer claims that the Debtor's obligations to it are nondischargeable pursuant to §523(a)(2)(A). Section 523(a)(2)(A) provides as follows:

> (a)A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt– ...
>
> > (2)for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by--
> >
> > (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition; ....

In order for a debtor's representation to constitute a false pretense or a false representation it generally must have been – (1) a knowing and fraudulent falsehood, (2) describing past or current facts, (3) that was justifiably relied upon by the other party. *RecoverEdge L.P. v. Pentecost*, 44 F.3d 1284, 1292-93 (citing *In re Bercier*, 934 F.2d 689, 692 (5th Cir. 1991) ("[T]o be a false representation or false pretense under § 523(a)(2), the false representations and false pretenses [must] encompass statements that falsely purport to depict current or past facts.")). The Fifth Circuit has held, for example, that a debtor's promise to add a term to a contract at a future date was a fraudulent misrepresentation

because the debtor had no intention of performing as promised. *Matter of Allison*, 960 F.2d 481, 484 (5th Cir. 1992). The distinction recognized by the Fifth Circuit is a chronological one, resting upon whether a debtor's representation is made with reference to a future event as opposed to a representation regarding a past or existing fact. *See In re Bercier* ,934 F.2d 689, 692 (5th Cir. 1991) ("[A debtor's] promise...related to [a] *future action* [which does] not purport to depict current or past fact...therefore cannot be defined as a *false representation or a false pretense*.") (quoting *In re Roeder*, 61 B.R. at 181) (changes and emphasis in original).

Here, with regard to the Consignment Agreement, the Debtor never complied with the requirement that he pay Parker Trailer immediately upon each sale, and Parker Trailer never withheld the titles to the trailers pending receipt of the sales proceeds. Parker Trailer also did not insist on strict compliance with the payment terms in the Consignment Agreement, accepting periodic payments from the general operating accounts for Southwest Trailer, Inc. without complaint. *See, e.g., Cal-Tex Lumber Co., Inc. v. Owens Handle Co., Inc.,* 989 S.W.2d 802, 812 (Tex. App. – Tyler 1999) (discussing waiver and avoidance of waiver of contract terms). In light of the parties' course of conduct, the Court concludes that Parker Trailer has failed to sustain its burden of proof on a claim pertaining to a false representation under §523(a)(2)(A) as to the Consignment Agreement.

In contrast, with regard to the Debtor's payment and reporting obligations under the Floorplan Agreement, the Court finds that the Debtor had no intention of performing as

promised. According to the Debtor's testimony, the market for trailers had fallen, and he was using the proceeds from the sales of Parker Trailer's property to fund his increased payroll and other expenses related to his attempt to grow his business at the time he entered into the Floorplan Agreement. The Debtor never complied with the new payment and reporting requirements in the Floorplan Agreement, and there was no intervening event that prevented him from doing so. There also was no evidence that the Debtor was expecting to receive income from any source other than his businesses. Under these circumstances, the Court finds that the Debtor falsely represented his ability and intent to perform under the Floorplan Agreement. The Court, therefore, concludes that Parker Trailer has sustained its burden of proof on a claim pertaining to a false representation under §523(a)(2)(A) as to the Floorplan Agreement and the thirty trailers sold by the Debtor between Parker Trailer's inventories on March 28, 2002 and April 25, 2002.

2. Section 523(a)(4)

Parker Trailer also argues that the Debtor embezzled funds belonging to Parker Trailer and, therefore, that the Debtor's obligations to it are not dischargeable pursuant to §523(a)(4).[6] A claim involving embezzlement is excepted from discharge by §523(a)(4), as follows:

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[6]In the First Amended Complaint, Parker Trailer alleged that the Debtor committed larceny and actual fraud while acting in a fiduciary capacity and, therefore, that his obligations to Parker Trailer are not dischargeable pursuant to §523(a)(4). The parties' pretrial order generically stated that the parties disputed whether the Debtor had violated §523(a)(4). In its post-trial brief, however, Parker Trailer argued that it should receive a judgment of nondischargeability because the Debtor embezzled its property. It is not clear that Parker Trailer's embezzlement claim is properly before this Court. In light of the Court's rejection of Parker Trailer's embezzlement claim, discussed below, the Court need not reach this issue.

> A discharge under section 727, 1141, 1228(a), 1228(b) or 1328(b) of this title does not discharge an individual debtor from any debt – . . . .
>
> > (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny . . . .

Section 523(a)(4) "was intended to reach those debts incurred through abuses of fiduciary positions and through active misconduct whereby a debtor has deprived others of their property by criminal acts; both classes of conduct involve debts arising from the debtor's acquisition or use of property that is not the debtor's." *Miller v. J.D. Abrams Inc. (Matter of Miller)*, 156 F.3d 598, 602 (5th Cir. 1998) (citation omitted).

Embezzlement is defined for the purposes of §523(a)(4) as the "fraudulent appropriation of property by a person to whom such property has been entrusted, or into whose hands it has lawfully come." *See Miller*, 156 F.3d at 602 (citations omitted). Thus, "[a] creditor proves embezzlement by showing that he entrusted his property to the debtor, the debtor appropriated the property for a use other than that for which it was entrusted, and the circumstances indicate fraud." *Brady v. McAllister (In re Brady),* 101 F.3d 1165, 1173 (6th Cir.1996); *State of New York v. Sokol (In re Sokol),* 170 B.R. 556, 560 (Bankr. S.D.N.Y. 1994); *cf. Coburn Co. v. Nicholas,* 956 F.2d 110, 111 (5th Cir.1992) (requiring an intent to defraud for a determination that there has been a breach of a fiduciary relationship under § 523(a)(4)). Additionally, there must be proof of the debtor's fraudulent intent in taking the property. *See Miller*, 156 F.3d at 602 (citations omitted).

In the context of consignment agreements, various courts have recognized an

exception to the definition of embezzlement where a debtor has the right to co-mingle the funds that are owed. *See, e.g., Snap-On Tools Corp. v. Rigsby (In re Rigsby)*, 18 B.R. 518 (Bankr. Va. 1982) (no embezzlement where debtor had unrestricted use of funds from sale of consignor's property). These courts reason that "[w]here a debtor is not required to isolate funds in a separate account and has unrestricted use of the funds, the complainant is merely an unpaid creditor rather than the victim of embezzlement." *Rentrak Corp. v. Cady (In re Cady)*, 195 B.R. 960, 966 (Bankr. S.D. Ga. 1996). In other words, if the debtor is lawfully entitled to use the funds, the debtor's duty to pay the consignor is simply based on its obligations as a debtor. *See, e.g., Commonwealth of Virginia Comm'n of Game and Fisheries v. Myers (In re Myers)*, 52 B.R. 901, 907 (Bankr. E.D. Va. 1985). In determining whether a debtor may lawfully use the funds from the sale of a consignor's property, the parties' course of dealing controls over the terms of a written consignment agreement. *See In re Cady*, 195 B.R. at 966; *see also, e.g., Fairfield Fin. Group, Inc. v. Gawerc*, 814 S.W.2d 204 (Tex. App. – Houston [1st Dist.], 1991, no writ) (under Texas law, right to performance of a contract may be waived by express or implied assent to nonperforming conduct).

In this case, the Debtor had discretion to sell Parker Trailer's property so long as Parker Trailer's portion of the sales proceeds was remitted to Parker Trailer. Although the written agreements between the parties provided that the sales proceeds would remain the property of Parker Trailer, neither the Consignment Agreement nor the Floorplan Agreement required the Debtor to isolate these funds in a trust account. The Debtor had unrestricted use

of the funds in his possession, and the Debtor did not deceive Parker Trailer regarding the deposit of the sales proceeds into the general operating accounts for Southwest Trailer, Inc. Even after Parker Trailer discovered the Debtor was using the proceeds from the sale of its trailers to fund his floundering businesses, Parker Trailer did not seek to prevent the Debtor from depositing the proceeds from the sale of its trailers into Southwest Trailer, Inc.'s general operating accounts. The Floorplan Agreement simply required periodic financial reporting and imposed a deadline for the Debtor to forward the sales proceeds to Parker Trailer. Under these circumstances, the Court concludes that Parker Trailer is simply a creditor of the Debtor, not the victim of embezzlement.

For the foregoing reasons, the Court concludes that Parker Trailer has not sustained the burden of proof on a claim pertaining to embezzlement under §523(a)(4).

3. Section 523(a)(6)

Finally, Parker Trailer argues that the Debtor's obligations to it are nondischargeable pursuant to §523(a)(6). Section 523(a)(6) excepts from discharge any debt "for willful and malicious injury by the debtor to another entity or to the property of another entity."

The U.S. Supreme Court recently examined whether the scope of §523(a)(6) encompasses all intentional acts that cause injury, or only acts done with an actual intent to cause injury. *Kawaauhau v. Geiger*, 523 U.S. 57 (1998). In *Geiger*, the U.S. Supreme Court stated that "[t]he word 'willful' in (a)(6) modifies the word 'injury,' indicating that nondischargeability takes a deliberate or intentional *injury,* not merely a deliberate or

intentional *act* that leads to injury." The Supreme Court concluded that to construe the statute more broadly -- *i.e.,* to find a debt nondischargeable if it arose from an intentional act that ultimately led to injury-- would wrongfully place within the excepted category a wide range of situations in which an act is intentional, but injury is unintended.

The *Geiger* decision clearly required that an actor inflict a deliberate or intentional injury, not merely that an actor take a deliberate or intentional act that leads to injury. That decision significantly narrowed the scope of debts which can be deemed nondischargeable under § 523(a)(6), and it prompted courts, including the Fifth Circuit, to engage in efforts to identify those deliberate or intentional actions involving an "actual intent to cause injury," as would be necessary to meet the definition of "willful" under *Geiger*.

In *In re Miller*, 156 F.3d at 603, the Fifth Circuit analyzed the *Geiger* ruling in an effort to articulate a methodology by which to distinguish between acts intended to *cause* injury as opposed to those merely *leading* to injury. It concluded that the mere fact that an action is traditionally identified as an "intentional tort" does not necessarily mean that any injury caused thereby is willful. It found the label of "intentional tort" to be "too elusive" to distinguish accurately between those two categories of intentional conduct. *Id*. at 603. Instead, the Fifth Circuit in *Miller* determined that a "willful...injury" is established under §523(a)(6) when there exists either: (1) an objective substantial certainty of harm arising from a deliberate or intentional action or (2) there is a subjective motive to cause harm by a party taking a deliberate or intentional action.

As the Fifth Circuit explained in *Raspanti v. Keaty (In re Keaty)*, 397 F.3d 264, 270 (5th Cir. 2005), it previously held in *Miller* that "malicious injury" does not mean an act without just cause or excuse. *See In re Miller,* 156 F.3d at 605. Instead, "malicious" is an act done with the actual intent to cause injury. *In re Miller,* 156 F.3d at 606. This definition is synonymous with the definition of "willful" and, therefore, the Fifth Circuit's decision in *Miller* aggregated "willful and malicious" into a unitary concept. In other words, the *Geiger* standard for determining the existence of a "willful" injury subsumes the former standard for determining "malicious" conduct under §523(a)(6) – *i.e.,* without just cause or excuse – and there is no need to conduct a separate analysis as to maliciousness. *Id*. at 604-06.

In summary, for willfulness and malice to prevent discharge under § 523(a)(6), the debtor must have intended the actual injury that resulted. *See Texas v. Walker*, 142 F.3d 813 (5th Cir. 1998). The holdings in *Geiger*, *Miller* and most recently, *Keaty* "indicate that a debtor must commit an intentional or substantially certain injury in order to be denied a discharge." *In re Williams*, 337 F.3d 504, 509 (5th Cir. 2003).

In this case, the Debtor deposited the proceeds from the sale of Parker Trailer's property into the general operating accounts for Southwest Trailer, Inc., and he periodically wrote checks to Parker Trailer from those accounts. This course of dealing continued for some period of time without Parker Trailer's dissent. The commingling of the proceeds from the sale of Park Trailer's property with the funds in the Southwest Trailer, Inc.'s general operating accounts became a problem as Southwest Trailer, Inc. began to fail.

Initially, the Debtor did not intend to injure Parker Trailer. He simply wrote checks on the accounts to pay general operating expenses as he had always done. However, by the time Parker Trailer conducted its March 2002 inventory of the Debtor's sales lot, he knew that he did not have sufficient funds to pay his general operating expenses as well as Parker Trailer. The Debtor nonetheless entered into the Floorplan Agreement with Parker Trailer and continued using the proceeds from Parker Trailer's property to pay his general business expenses. Under these circumstances, the Debtor's continued use of the proceeds from the sale of Parker Trailer's trailers to meet operating expenses was substantially certain to injure Parker Trailer when it became clear that he could not pay Parker Trailer as well as his employees and other creditors.

For the foregoing reasons, the Court concludes that Parker Trailer has sustained its burden of proof on a claim relating to willful and malicious injury under §523(a)(6) as to the Debtor's use of the proceeds of the thirty trailers sold by the Debtor after Parker Trailer's inventory of the Debtor's sales lot in March 2002.

CONCLUSION

Although Parker Trailer did not meet its burden to establish grounds for the denial of the Debtor's discharge under §727(a)(2)(A) or (a)(5), Parker Trailer established that the Debtor's obligations to it should not be discharged pursuant to §523(a)(2)(A) and (a)(6) as to the thirty trailers sold by the Debtor after Parker Trailer's inventory of the Debtor's sales

lot in March 2002. Accordingly, Parker Trailer is entitled to a judgment of nondischargeability in the amount of $64,513.10. The Court will enter a judgment incorporating this Memorandum Opinion.

Signed on 9/30/2005

Brenda T. Rhoades MD

HONORABLE BRENDA T. RHOADES,
UNITED STATES BANKRUPTCY JUDGE