Dated: June 30, 2015
The following was SIGNED:

David S. Kennedy
UNITED STATES CHIEF BANKRUPTCY JUDGE

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF TENNESSEE
WESTERN DIVISION

In re

KEITH TRAVIS HAYNES and
JENNY KAY HAYNES,

Case No. 13-32671-K

Joint Chapter 7

Debtors.

SSN: xxx-xx-5393(H)
SSN: xxx-xx-7270(W)

GARY C. BAYER and JANE P. BAYER,

Plaintiffs,

v.

Adv. Proc. No. 14-00120

KEITH TRAVIS HAYNES and
JENNY KAY HAYNES,

Defendants.

MEMORANDUM AND ORDER DENYING PLAINTIFFS' COMPLAINT UNDER 11 U.S.C. § 523(a)(2), (4), AND (6) COMBINED WITH RELATED ORDERS AND NOTICE OF THE ENTRY THEREOF

This adversary proceeding arises out of a complaint filed by the plaintiffs, Gary C. Bayer and Jane P. Bayer (collectively, "the Bayers"), under 11 U.S.C. § 523(a)(2)(A), (4), and (6), seeking to except from the general discharge certain pre-petition debts owed by the above-named debtors, defendants, Keith Travis Haynes and Jenny K. Haynes (collectively, "the Haynes"), to the Bayers. The Haynes subsequently filed an answer to the Bayers' complaint.

The ultimate question for judicial determination here is whether the Haynes committed acts in violation of 11 U.S.C. § 523(a)(2), (4), and (6) (e.g., some sort of fraud, larceny, willful or malicious injury, conversion, other intentional misrepresentation or the like), such that the particular debt owed to the Bayers should be deemed a statutory exception to the Haynes' Chapter 7 general discharges. On May 18, 2015, the court held a trial on the matter. Mr. Bayer and Mr. Haynes testified at trial, as did Mr. Corey Hawes on behalf of the Bayers. The Bayers, but not the Haynes, later submitted a post-trial brief.

This is a core proceeding under 28 U.S.C. § 157(b)(2)(I). The following shall constitute this court's findings of fact and conclusions of law in accordance with Rule 7052 of the Federal Rules of Bankruptcy Procedure.

BACKGROUND FACTS AND PROCEDURAL HISTORY

The pre- and postpetition background facts and judicial/procedural history here may be summarized, in relevant part, as follows. On February 20, 2013, the Bayers filed a "Complaint for Deficiency After Sale of Real Property, to Recover Personal Property, and for Judgment Sums Owed" (the "State Court Complaint") in the Chancery Court of Shelby County, Tennessee. The State Court complaint arose out of a transaction entered into between the Haynes and the Bayers involving the sale of residential real property located at 7860 Harbor Oak Cove, Cordova, Tennessee, in the original principal amount of $330,000. The transaction included a wraparound promissory note, a deed of trust on the real property, and also a security agreement pledging specific items of personal properties as additional collateral for the note.[1] The Haynes later defaulted on the note; and the Bayers instituted a foreclosure action in which the Bayers purchased the real property via a credit bid at the foreclosure sale for $227,670.

The Bayers subsequently filed a State Court complaint seeking, inter alia, possession of the personal properties pledged as collateral subject to the security agreement, as well as a monetary judgment for the deficiency realized as a result of the foreclosed residential real property in the amount of $138,638.20 representing the unpaid balance due and owing on the previously executed promissory note. Neither fraud, misrepresentation, nor false pretenses were alleged by the Bayers in the State Court complaint. A final judgment was entered in the Shelby County Chancery Court on June 26, 2013, pursuant to a motion for default judgment filed by the Bayers. The default judgment awarded the Bayers a judgment in the amount of $149,425.78, including post-judgment interest at 6% per annum on the unpaid balance.

On November 19, 2013, the Haynes filed a joint Chapter 7 petition under 11 U.S.C. § 302. In Schedule F accompanying their Chapter 7 petition, the Haynes included the monetary judgement owed to the Bayers in the amount of $154,000 and classified and described the debt as a "business debt." The deadline to file exceptions to the Haynes' general discharge[2] was extended to April 18, 2014. The Bayers timely commenced the instant adversary proceeding on April 11, 2014, by filing a complaint under 11 U.S.C. § 523(a)(2)(A), (4), and (6) and FED. R.

[1] Some of the personal properties pledged as collateral included, *e.g.*, 65 antique chairs (1929 Empire), 150 settings of bone china, 100 settings of china, a 2004 Ford Service van, and a 1990 Ford 350 truck. The security agreement indicated that the value of the personal properties pledged as collateral for the note totaled $50,500.
[2] *See* 11 U.S.C. § 727 *and* 11 U.S.C. § 523.

BANKR. P. 7001(6) seeking to except from the Haynes' discharges the default judgment previously awarded to the Bayers by the Shelby County Chancery Court.[3]

In responding to the Bayers' § 523(c) dischargeability complaint, the Haynes claimed, among other things, that the Bayers were given full access and opportunity to inspect and value the personal properties included in the security agreement and pledged as collateral prior to the transaction between the parties being consummated. Furthermore, the Haynes alleged that the Bayers withheld information regarding the condition of the real property that was the subject of this transaction. The Haynes further stated that not all of the personal properties pledged as collateral in the security agreement were ultimately retrieved for sale by the Bayers, as some of the collateral was missing. Apparently, the Bayers declined to repossess other items. Additionally, the Haynes asked this court to invoke the doctrine of collateral estoppel and claim preclusion since no allegations of fraud, conversion, or other intentional torts were alleged by the Bayers or determined in the State court lawsuit. *See Brown v. Felsen*, 442 U.S. 127 (1979), discussed more fully, infra.

The Haynes further sought the imposition and recovery of attorney's fees from the Bayers pursuant to 11 U.S.C. § 523(d), which provides that "[i]f a creditor requests a determination of dischargeability of a consumer debt under subsection (a)(2) of this section, and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's free for, the proceeding if the court finds that the position of the creditor was not substantially justified." *See* 11 U.S.C. § 523(d), supra. It is expressly noted that § 101(8) of the Bankruptcy Code defines the term "consumer debt" to mean a debt incurred by an individual primarily "for a personal, family, or household purpose."

[3] *See discussion supra*.

GENERAL DISCUSSION

The nation's bankruptcy laws exist to give honest debtors a fresh financial start in life unhampered by the burden and pressures of pre-existing debts. Denial of a debtor's general discharge is not to be taken lightly, and the statutory exceptions to the operations of a debtor's discharge should be confined to those plainly expressed. The general philosophy of the laws of Congress relating to bankruptcy is "to give the debtor a 'new opportunity in life and a clear field for future effort, unhampered by the pressure of discouragement of preexisting debt.'" *Lines v. Frederick*, 400 U.S. 18, 19 (1970). Exceptions to operations of a bankruptcy discharge are strictly construed against the creditor/objector and liberally in favor of the debtor. *Gleason v. Thaw*, 236 U.S. 558 (1915); *In re Ward*, 857 F.2d 1082, 1082 (6th Cir. 1988); *In re Rembert*, 141 F.3d 277, 281 (6th Cir. 1998).

BROWN V. FELSEN

In *Brown v. Felsen*, 442 U.S. 127 (1979), the debtor/defendant stipulated that the creditor/plaintiff should have a judgment against the debtor. However, it is noted that the plaintiff, as here, did not allege grounds to except the debt from a bankruptcy discharge. Shortly thereafter, the debtor sought relief under the former Bankruptcy Act. The Supreme Court held that the bankruptcy court is not confined to a review of the judgment and record in the prior state court litigation when determining the subsequent bankruptcy dischargeability of the debtor/defendant's debt and may consider evidence extrinsic to the prepetition judgment when ascertaining whether a debt previously reduced to judgment is dischargeable under § 17 of the former Bankruptcy Act. 11 U.S.C. § 35 (now 11 U.S.C. § 523).

When a debtor subsequently asserts the new defense of bankruptcy, the doctrine of res judicata does not bar the creditor from offering additional evidence to meet that defense.

Actually, a contrary rule would force premature federal issues on the State courts and would frustrate the command of the Bankruptcy Code that only honest debts are to be discharged in bankruptcy. Debts arising out of, for example, fraud, embezzlement, conversion, etc. are to be excepted from a general discharge in bankruptcy, and the mere fact that a conscientious creditor has reduced its claim to judgment should not bar further inquiry into the true underlying nature of the debt. Whereas res judicata forecloses all that might have been litigated previously, the doctrine of collateral estoppel treats as final only those questions actually and necessarily litigated and decided in a prior prepetition suit. *Grogan v. Garner*, 498 U.S. 279 (1991). Questions of fraud, larceny, conversion, and the like were not actually and necessarily listed in the prepetition litigation involving these parties.

Refusing to apply the doctrine of res judicata here would permit the bankruptcy court to make an accurate and fairer determination whether the Haynes, in fact, committed the deceit, fraud, malicious conversion, etc., which the Bayers allege. Such refusal here also comports with the holding in *Brown v. Felson*. These questions are now, for the first time, squarely at issue involving these parties. They are the type of questions Congress intended the bankruptcy court to ordinarily resolve. 11 U.S.C. § 523(c). The bankruptcy court can weigh all the evidence, and it can also take into account whether or not the creditor's failure to press these allegations at an earlier time betrays a weakness in the case on the merits. As such, in the present proceeding, the doctrine of collateral estoppel does not prevent this court from hearing and ruling on the merits of the Bayers' claim seeking to except from general discharge the debts owed by the Haynes to the Bayers.

<u>11 U.S.C. § 523(a)(2)(A)</u>

From the debtor's viewpoint, the purpose of filing a Chapter 7 bankruptcy case is ordinarily two-fold: First, it statutorily gives rise to an automatic stay to give the debtor a "breathing spell." 11 U.S.C. § 362(a). Secondly, once the debtor has successfully completed all requirements, the debtor will be entitled to a discharge of all dischargeable debts, assuming no timely objections to the general discharge have been filed and sustained. 11 U.S.C. § 524.

Section 523(a)(2)(A) of the Bankruptcy Code was intended to codify case law as expressed in *Neal v. Clark*, 95 U.S. 704 (1887), which interpreted "fraud" to mean actual or positive fraud rather than fraud implied by law. 124 Cong. Rec. H. 11,095.6 (daily ed. Sept. 28, 1978); S 17,412-13 (daily ed. Oct. 6, 1978). A false representation or false pretense under § 523(a)(2)(A) must be of a kind involving moral turpitude or intentional wrong. It is noted that fraud implied in law may exist without imputation of bad faith or immorality and is insufficient. *See In re Green*, 5 B.R. 247 (Bankr. N.D. Ga. 1980).

To except a specific debt from a general discharge under 11 U.S.C. § 523(a)(2)(A), a creditor must prove the elements set forth in, for example, *In Re McLaren*, 3 F.3d 958, 961 (6th Cir. 1993). The creditor must provide evidence:

1. that the debtor obtained money though a material misrepresentation that, at the time, the debtor knew was false or made with gross recklessness as to its truth;
2. of the debtor's intent to deceive;
3. that the creditor reasonably relied on the false representation; and
4. reliance was the proximate cause of the loss.

Id. at 961. These elements must be established by a preponderance of the evidence. *Id.* The court will now consider each factor in turn.

Section 523(a)(2)(A) of the Bankruptcy Code provides that a general discharge "does not discharge an individual debtor from any debt [. . .] for money, property, services, or an extension, renewal, or refinancing or credit, to the extent obtained by [. . .] false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition." 11 U.S.C. § 523(a)(2)(A). If the property or services were obtained by the debtor prior to the making of any false representation, subsequent misrepresentation will have no effect upon the discharge of the debtor – *i.e.*, fraud must exist in the inception of the contract or transaction. Here, the Bayers have provided no evidence that, at the inception of the contract, the transaction with the Haynes was founded upon actual, positive fraud. While the Bayers propose that the Haynes were not forthcoming in the valuations of the personal properties that were to be pledged as collateral for the loan, Mr. Haynes, in fact, provided testimony that the Bayers were afforded an opportunity to view and value the personal properties prior to the consummation of the transaction. This negates the notion that the Bayers were fraudulently induced to enter into the transaction, as the condition and value of the properties were made available to the Bayers prior to the completion of the transaction. The fact that the value of the personal properties at the time of inventory and foreclosure was less than it was initially believed to be does not rise to the level of actual or positive fraud necessary to meet this element.

Furthermore, in *In re Rembert* the Sixth Circuit held that "[w]hether a debtor possessed an intent to defraud a creditor within the scope of § 523(a)(2)(A) is measured by a subjective standard." *In re Rembert*, 141 F.3d 277, 281 (6th Cir. 1998) (citing Field v. Mans, 516 U.S. 59, 111 S.Ct. 654, 661, 112 L.Ed.2d 351 (1995)). The focus is on the debtor's subjective intent and whether the debtor intended to deceive the creditor in such a way as to induce him to enter into the contract or transaction. Admittedly, this is a difficult burden to meet and overcome. The court has not been presented with sufficient evidence of a subjective intent on behalf of the Haynes to fraudulently entice the Bayers to enter into the transaction here. In fact, the Haynes seemed to want to ensure payment of their debt in as much as they gave the Bayers, not only a wrap around promissory note and a deed of trust on the real property in question, but also several items of personal properties to pledge as additional collateral to secure the loan. The court finds that, with the facts as presented here, the Bayers have failed to meet the heightened burden of proving a subjective intent to defraud on behalf of the Haynes that would render the debt non-dischargeable under 11 U.S.C. § 523 (a)(2).

Thirdly, the Supreme Court in *Field v. Mans*, 516 U.S. 59, 116 S.Ct. 437 (1995), changed the Sixth Circuit *McLaren* reliance standard for creditors from the objective “reasonable” standard to the more “intermediate” justifiable standard. *Id.* at 73, 445. In other words, a creditor may still be able to meet the burden of proof under 11 U.S.C. § 523(a)(2) required to render the debt owed non-dischargeable by showing reliance on the false statement or misrepresentation, while possibly unreasonable and easily discoverable with further investigation, was not completely illegitimate. Nonetheless, as previously stated, the Bayers have failed to provide sufficient evidence showing that the Haynes committed intentional, positive, or actual fraud at the inception of the transaction by a preponderance of the evidence thereby creating sufficient statutory grounds on which they could successfully rely. Accordingly, the Bayers cannot prove justifiable reliance on the asserted fraudulent conduct attributable to the Haynes that has not been adequately proven to exist.

As the court has previously noted, the Bayers have failed to adequately show subjective actual, or positive fraudulent conduct on behalf of the Haynes, involving, for example, moral turpitude or intentional wrong. Accordingly, the court will not address whether the asserted fraudulent conduct was the proximate cause of the injury here.

11 U.S.C. § 523(a)(4)

Section 523(a)(4) of the Bankruptcy Code also excepts from a debtor's general discharge particular debts obtained by "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. § 523(a)(4). The court will consider each of these in turn. However, as noted above, fraud has been defined as actual or positive fraud, as opposed to implied fraud.[4] Considering a totality of the particular facts and circumstances, the court finds that adequate evidence establishing positive fraud at the inception of the transaction on behalf of the Haynes does not exist here. As the Bayers have failed to show fraud or the like in order to prevail under 11 U.S.C. § 523 (a)(2), so, too, do they fail to show, by a preponderance of the evidence, actual or positive fraud under 11 U.S.C. § 523(a)(4).

The Supreme Court recently held that an exception to discharge due to defalcation requires the debtor to possess a "culpable state of mind [. . .], one involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior." *Bullock v. BankChampaign, N.A.*, 133 S.Ct. 1754, 1757, 185 L.Ed.2d. 922 (2013). As such, and according to the Sixth Circuit, the creditor seeking to have the debt owed him excepted from the general discharge must prove the requisite intent, as well as the following, by a preponderance of the evidence:

1. a pre-existing fiduciary relationship,
2. a breach of that relationship, and
3. resulting loss.

[4] See discussion *supra*.

In re Patel, 565 F.3d 963, 968 (6th Cir. 2009) (other citations omitted); *See also In re Garver*, 116 F.3d 176, 178 (6th Cir. 1997). The fiduciary relationship contemplated here is much narrower, as "section 523(a)(4) covers only 'express' or 'technical trusts' and not trusts arising out of 'the very act of wrongdoing.'" *Id.* (citing *Davis v. Aetna Acceptance, Co.*, 293 U.S. 328, 333, 55 S.Ct. 151 (1934)). Here, the Bayers have not provided the court with sufficient evidence to establish that a trust was in fact in existence and established between the Bayers and the Haynes, rendering the final two elements of defalcation inapplicable. The absence of an express trust, therefore, does not create the fiduciary capacity requirement of the defalcation component in order to effectively except a specific debt from the general discharge.

A second and separate method of rendering a debt non-dischargeable under 11 U.S.C. 523(a)(4) is by proving embezzlement or larceny on behalf of the debtor.[5] "Embezzlement is generally defined under federal law as 'the fraudulent appropriation of property by a person to whom such property has been intrusted or into whose hands it has lawfully come.'" *Gribble v. Carlton*, 26 B.R. 202, 205 (Bankr. M.D. Tenn. 1982)(quoting *Moore v. U.S.*, 106 U.S. 268, 269 (1895)). Similar to embezzlement, larceny is the "wrongful taking and carrying away of property of another with intent to convert the property." *See* ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY § 523.10 (2013). Larceny, unlike embezzlement, requires an intent to take the property at the outset of the act, whereas embezzlement begins as lawful possession of the property with a later formed intent to convert the property. In order to successfully prove embezzlement, a creditor must show the following elements:

1. appropriation of funds for the debtor's own benefit by fraudulent intent or deceit;
2. the deposit of the resulting funds in an account accessible only to the debtor; and

[5] No fiduciary capacity must be shown in order to prevail under this theory.

3. the disbursal or use of these funds without explanation of reason or purpose.

See ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY § 523.10 (2013) (citing *In re Bryant*, 147 B.R. 507 (Bankr. W.D. Mo. 1992)). However, "it is improper to automatically assume embezzlement has occurred merely because property is missing." ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY § 523.10 (2013). Mr. Bayer testified that some of the personal properties pledged as collateral for the loan were missing at the time of the desired repossession and/or foreclosure. The simple fact that property was missing, whereby the majority of the personal property still remained, is insufficient to carry the burden of showing that embezzlement has occurred. In fact, Mr. Haynes testified that the personal property had been held in storage (over which the Haynes had no control) for approximately 10 years prior to the Bayers' inventory and repossession of the property. The lapse of time and the absence of proof of intent fall far short of the elements required for embezzlement.

<u>11 U.S.C. § 523(a)(6)</u>

To prevail under 11 U.S.C. § 523(a)(6), a plaintiff/creditor must prove that injury to the creditor's property was the result of the defendant/debtor's "willful and malicious" acts or conduct. Willful and malicious, however, are not statutorily defined terms. The Supreme Court in *In re Geiger* held that willful and malicious injury required more than an intentional act that caused an injury, and instead concerned "only acts done with the actual intent to cause injury." 523 U.S. 57, 61, 118 S.Ct. 974 (1998); *see also In re Markowitz*, 190 F.3d 455, 464-66 (6th Cir. 1999)(adopting the Supreme Court's subjective definition of "willful and malicious").

In other words, the debtor must have intended the harm that actually occurred in order to have the debt owed non-dischargeable as a result of that conduct. Here, the Bayers allege that the Haynes wrongfully converted personal properties that were the subject of the security agreement between the parties, thus rendering the debt owed non-dischargeable under § 523(a)(6). While the tort of conversion is a type of misconduct contemplated to satisfy the standard of "willful and malicious" conduct,[6] the creditor must still prove, by a preponderance of the evidence, that the unlawful conversion was the injury actually intended by the debtor.

The Bayers have not produced sufficient proof to meet this stringent standard of willful and malicious conduct under § 523 (a)(6). In fact, the Bayers have only proffered testimony that some of the collateral pledged in the security agreement was not recovered upon the default by the Haynes. While absence of some of the personal property might raise an inference of conversion, this inference does not rise to the level required to render this debt non-dischargeable under 11 U.S.C. § 523(a)(6). Moreover, Mr. Haynes testified, as noted earlier, that some of the personal properties pledged to the Bayers in the security agreement had been in storage for 10 years before the Bayers sought possession of the property! This lapse of time weighs against the creditor here, as does the absence of evidence of the Haynes' willful, malicious, and ill intent.

11 U.S.C. § 523(d)

Section 523(d) of the Bankruptcy Code, supra, provides that in the event "a creditor requests a determination of dischargeability of a "consumer debt" under subsection (a)(2) of this section, and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, the proceeding if the court finds that the position of the creditor was not substantially justified." *See* 11 U.S.C. § 523(d). In other words, if a creditor files a complaint seeking to prevent a debtor from receiving a discharge of a "consumer debt"

[6] *See, e.g.*, *In re Best*, 109 F. App'x 1, *5 (6th Cir. 2004)("Debts arising out of these types of misconduct satisfy the willful and malicious injury standard: intentional infliction of emotional distress, malicious prosecution, *conversion*, assault, false arrest, intentional libel, and deliberately vandalizing the creditor's premises.")(*emphasis added*)(other citations omitted).

and is unsuccessful, the court may award attorney's fees and costs to the debtor for having to defend such suit if the complaint seeking exception to discharge was, in fact, unwarranted or illegitimate.

In *In re Carman*, 723 F.2d 16 (6th Cir. 1983), the Sixth Circuit held that the only exception whereby a debtor would not be awarded attorney's fees for defending a dischargeability complaint for a consumer debt filed by a creditor would be if the court determined the award of fees "clearly inequitable." *Id.* at 17. "Once it is determined that the debt is dischargeable, the unsuccessful creditor has the burden of proving that the imposition of attorney's fees would be clearly inequitable." *Id.* (citations omitted). The unsuccessful creditor has carried his burden of proof here. Thus, this is a distinction without a difference as to whether the underlying debt is a consumer or a business debt—it makes no difference. Considering a totality of the particular facts and circumstances, the Bayers have met their burden here that this complaint seeking an exception to the general discharge of the Haynes was substantially justified. 11 U.S.C. § 523(d); *See also In re Carmen*, 723 F.2d 16 (6th Cir. 1983).

<u>CONCLUSION</u>

Based on all the foregoing and strictly construing the Bayers' § 523(c) exceptions to discharge against the Bayers and liberally in favor of the Haynes, the Bayers' dischargeability complaint is denied. The Bayers have not met the required burden of proof by a preponderance of the evidence that, under the particular facts and circumstances presented here, the debt owed to them by the Haynes should be excepted from the Haynes' general discharges. Clearly, there is certainly not a sufficient record to even remotely consider holding Mrs. Haynes accountable. The debt owed by the Haynes to the Bayers in this case will be a subject of the general discharge provisions of 11 U.S.C. § 524.

Bankruptcy Court Clerk shall cause a copy of this Order and Notice to be sent to:

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