UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF TENNESSEE

IN RE:

TERRY D. WHITE, **Case No. 01-28162-WHB**

Debtor.

SECURAMERICA BUSINESS CREDIT,

Plaintiff,

v. **Adv. No. 01-0847**

TERRY D. WHITE,

Defendant.

MEMORANDUM OPINION ON COMPLAINT OBJECTING TO DISCHARGE AND TO DETERMINE DISCHARGEABILITY

The trial of this adversary proceeding was held on August 11, 2003, for the Court's determination of objection to general discharge and the dischargeability of Terry White's ("the Debtor's") debt to SecurAmerica Business Credit ("SecurAmerica") arising from the Debtor's personal guaranty of a loan from SecurAmerica to Danny's Premier Seafood, Inc. ("Premier"), the corporation in which the Debtor was a 50% shareholder and officer. SecurAmerica alleges in its complaint that the Debtor should be denied a general discharge pursuant to 11 U.S.C. § 727(a), or alternatively, that its debt is nondischargeable under the fraud exception to discharge set forth in 11 U.S.C. § 523(a)(2)(A) and (B), or the exception of § 523(a)(4). The Debtor has filed a counter-

complaint based on § 362(h) seeking damages for SecurAmerica's alleged willful violations of the automatic stay.

The determinative issue in the proceeding is whether the Debtor committed fraud against the Plaintiff after she learned that Premier's other officer had manipulated the books of Premier but she failed to alert SecurAmerica of that fact. Related to that issue is the extent of damages that may be nondischargeable. For the reasons set forth below, the Court determines that the Debtor had a duty to disclose to SecurAmerica her knowledge that the financial information being submitted to SecurAmerica by the other shareholder of Premier in order to obtain financing was false, and the Debtor's failure to disclose the information constitutes actual fraud for purposes of dischargeability of the debt under § 523(a)(2)(A), but the Court is unable to determine the amount of the nondischargeable debt from the evidence presented at this point. The Court further concludes that a denial of the Debtor's general discharge under § 727(a) is not warranted under the facts and circumstances existing in this case, and that the Debtor's counter-complaint for damages arising from SecurAmerica's alleged willful violation of the automatic stay should be denied. The following constitutes the Court's findings of fact and conclusions of law pursuant to FED. R. BANKR. P. 7052. This is a core proceeding. *See* 28 U.S.C. § 157(b)(2)(A) and (b)(2)(I).

FACTUAL SUMMARY

The Debtor and Mr. Zack M. Zakarian were each 50% shareholders in a seafood company known as Danny's Premier Seafood, Inc. Mr. Zakarian was president and treasurer of the company, and the Debtor was secretary. It is undisputed that the Debtor's corporate responsibility was to handle sales on a day-to-day basis, and Mr. Zakarian was solely responsible for the financial aspects of the company, including accounting and bookkeeping. The Debtor testified that Mr. Zakarian

drew a sharp line between their corporate duties and prevented her from invading his area. She also testified that she had no knowledge of accounting procedures and that she did not understand much of what Mr. Zakarian did. Mr. Zakarian was the "collateral guarantor" in the loan documentation, and Ms. White apparently did not execute such an agreement, although she did witness Mr. Zakarian's Guaranty of Validity of Collateral. Attachment E to Exhibit 1 [loan closing documents].

In 1998 Premier entered into a revolving credit agreement with SecurAmerica, granting SecurAmerica a security interest in all of Premier's assets, including accounts receivable. Under the terms of the agreement, SecurAmerica required Premier to prepare and submit Borrowing Base Certificates on a weekly basis, which contained information regarding the status of the SecurAmerica debt, accounts receivable, and inventory. In addition, on March 31, 1998, the Debtor executed a personal guaranty for payment of the corporation's debt to SecurAmerica. Her personal guaranty is significant, since it takes her obligations to SecurAmerica beyond the normal shareholder or officer obligations. Moreover, the guaranty specifically states that she "guarantees that the Liabilities [of Premier] will be paid and performed strictly in accordance with the terms of the [loan] Agreement...." Attachment D to Exhibit 1.

At some point prior to Premier's bankruptcy, Mr. Zakarian began to maintain two sets of books for the company. In one set of books the accounts receivable balances were artificially inflated, and it was this set of accounts that was the basis of the Borrowing Base Certificates that were presented to SecurAmerica for the purpose of obtaining draws on the corporation's loan. It is undisputed that the books showing artificially inflated assets were prepared, signed and submitted solely by Mr. Zakarian. The Debtor testified that she learned from Mr. Zakarian between June and September of 2000 that discrepancies existed between the actual assets and accounts of the

corporation and the accounts as presented to SecurAmerica. The Debtor testified that she told Mr. Zacharian at that time to "get it right" and that she never discussed the accounting issues with Mr. Zakarian again until the parties were meeting with an attorney to discuss a sale of the corporation near the end of the year 2000. The Debtor never disclosed the inflated accounts receivable balances to SecurAmerica, although a witness for the lender testified that Ms. White was present when the accounts receivable, especially the Kroger accounts, were discussed in meetings during 2000. Ms. White indicated that Kroger's delinquency in paying its significant account balances contributed to Premier's failure. Thus, her knowledge of the Kroger and other receivables was important to the company and to SecurAmerica. In January, March and May of 2000, the credit agreement between Premier and SecurAmerica was modified, increasing the maximum credit limit. Exhibits 3, 4, and 5. These were the third, fourth and fifth amendments to the agreement, with prior increases in the credit limit having occurred in September and December, 1998. See Exhibit 3 for reference to prior amendments. Subsequent to the last amendment in May of 2000, Premier's business failed. Premier filed its own bankruptcy, and the corporation's assets, including accounts receivable, were liquidated by SecurAmerica in early 2001. SecurAmerica is left with a substantial unsecured debt, approximately $800,000.

The Debtor commenced her chapter 7 bankruptcy case on June 4, 2001, and, obviously, SecurAmerica is pursuing its personal guaranty against the Debtor, as well as seeking a nondischargeble debt.

COMPLAINT ALLEGATIONS

SecurAmerica alleges in its complaint that the Debtor's general discharge should be denied under § 727(a)(3) because the Debtor falsified information from which the Debtor's financial

condition or business transactions would be ascertained. In addition, SecurAmerica claims that the debt is nondischargeable under § 523(a)(2)(A) as a debt for money obtained by false pretenses, a false representation, or actual fraud. Further, the complaint alleges that the debt is nondischargeable under § 523(a)(2)(B) as a debt for money obtained by use of a false financial statement. And, in its closing argument, the Plaintiff adds § 523(a)(4), the fraud and defalcation exception. Based on these allegations, SecurAmerica seeks a nondischargeable judgment in the amount of $795,000.

In her defense the Debtor contends that, although she had a very general knowledge of the accounting system used by Premier, her responsibility was in sales, and she had no role in formulating or creating financial reports. She also argues that she made no representations to SecurAmerica, did not participate in any financial meetings or negotiations, and did not sign or endorse any of the false financial statements submitted by Mr. Zakarian. In addition, the Debtor has filed a counter-complaint against SecurAmerica, alleging that SecurAmerica willfully violated the automatic stay by telephoning her after her bankruptcy filing on three occasions to discuss repayment of Premier's debt. In that counter-complaint, the Debtor seeks compensatory damages and also punitive damages of up to $1,000,000 resulting from the alleged violations.

SecurAmerica denies the Debtor's counter-complaint allegations, contending that two calls were made seeking the Debtor's assistance with liquidating the corporation's assets, and not for the purpose of discussing repayment of the debt.

ISSUE

The principal issue is whether the Debtor had a duty to disclose her knowledge of the discrepancy in the books of Premier to SecurAmerica, thus rendering her failure to disclose that fact fraudulent for purposes of dischargeability. A further issue, not raised by the parties, is the extent

of damages that may be subject to nondischargeability.

DISCUSSION, FINDINGS AND CONCLUSIONS

SecurAmerica alleges that the Debtor's conduct warrants a denial of her general discharge under § 727(a)(3). That section provides:

> (a) The court shall grant the debtor a discharge, unless –
> (3) the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case.

11 U.S.C. §727(a)(3). A finding that the Debtor should be denied a general discharge is without merit under the facts and circumstances existing in this case. It is undisputed that Mr. Zakarian was solely responsible for the accounting and bookkeeping aspects of the corporation's business, that he personally falsified the corporation's books and accounting records, and that he presented a false financial report or reports on Premier's condition to SecurAmerica in order to obtain more extensions of credit. Section 727(a)(3), by its express terms, requires such conduct on the part of a debtor before a debtor's general discharge will be denied. Such facts simply do not exist in this case. Ms. White had no role in falsifying the books of Premier; in fact, Mr. Zakarian excluded her from the accounting area of the company, an area which she did not understand. Her sole area of responsibility was sales. The Court notes that SecurAmeria obtained a consensual nondischargeable judgment against Mr. Zakarian in his personal bankruptcy for $100,000. The Court concludes that Ms. White's general discharge shall not be denied, leading to the issue of whether a specific debt to SecurAmerica is excepted from discharge.

SecurAmerica asserts that its debt incurred as a result of the Debtor's personal guaranty is

nondischargeable under the fraud exceptions to discharge set forth in § 523(a)(2)(A), (a)(2)(B), and (a)(4). Section 523(a)(2)(A) provides as follows:

> (a) A discharge under section 727 . . . does not discharge an individual debtor from any debt –
>
> (2) for money . . . 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.

11 U.S.C. § 523(a)(2)(A). Subsection (a)(2)(B) excepts debts resulting from the use of a written financial statement, and (a)(4) of § 523 excepts from discharge any debt for fraud or defalcation while acting in a fiduciary capacity. For the same reasons that the Court denied relief under § 727(a)(3), relief under § 523(a)(2)(B) is not appropriate: There is no proof that Ms. White prepared or personally presented to SecurAmerica any written financial statement, either for the corporation or herself.

As to fraud, the Plaintiff cites to the seminal Sixth Circuit case of *BancBoston Mortgage Corp. v. Ledford (In re Ledford)*, 970 F.2d 1556 (6th Cir.), *reh'g denied* (1992), in support of its argument that Mr. Zakarian's fraudulent acts should be imputed to the Debtor. However, the *Ledford* case and its progeny, which imputes the fraud of one business partner to an innocent partner if the fraud was perpetrated in the course of the partners' business and if the innocent partner somehow benefitted from the fraud, is inapplicable in this case. As SecurAmerica acknowledges, the *Ledford* line of cases, most often hinging on whether the innocent partner benefitted, is based on state law theories of partnership and agency law. In this case, the parties were shareholders of a corporation, and the Court has found no authority to support the allegation that the fraudulent acts

of one shareholder may be imputed to another, innocent shareholder.[1]

Furthermore, even though the express provisions of § 523(a)(2)(A) do not limit to the debtor fraudulent actions that render a debt nondischargeable, the legislative history of that subsection indicates that Congress intended the discharge exception to have such a limitation. The House and Senate Reports for the Bankruptcy Reform Act of 1978 state that "'actual fraud' is added as a ground for exception from discharge." H.R. REP. NO. 595, 95th Cong, 1st Sess 364 (1977); S. Rep. No. 989, 95th Cong, 2d Sess 78 (1978). The legislative history further states that "[s]ubparagraph (A) [of § 523(a)(2)] is intended to codify current case law e.g., Neal v. Clark, 95 U.S. 704 (1887), which interprets "fraud" to mean actual or positive fraud rather than fraud implied in law." 124 Cong Rec H11095-96 (daily ed. Sept. 28, 1978; S17412 (daily ed. Oct. 6, 1978); remarks of Rep. Edwards and Sen. DeConcini. For further discussion, see Theresa J. Pulley Radwan, *Determining Congressional Intent Regarding Dischargeability of Imputed Fraud Debts in Bankruptcy,* 54 MERCER L. REV. 987 (2003).

Because the fraudulent conduct of Mr. Zakarian cannot be imputed to the Debtor in this case, in order to find SecurAmerica's debt nondischargeable under § 523(a)(2)(A), the Court must determine that the Debtor's personal failure to disclose her knowledge about the discrepencies in the corporation's accounting records constitutes fraud. The Debtor correctly points out that general corporate law in Tennessee protects a shareholder from personal liability, but exceptions do exist to that generality. "A shareholder of a corporation is not personally liable for the acts or debts of

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[1] The Court notes that some courts have imputed liability of a corporation to a shareholder on the basis that the shareholder was the alter ego of the corporation, but this scenario is also inapplicable to the case at bar. *See Tobin v. Sans Souci Ltd. Partnership (In re Tobin)*, 258 B.R. 199 B.A.P. 9th Cir. 2001).

the corporation except that the shareholder may become personally liable by reason of the shareholder's own acts or conduct." TENN. CODE ANNOT. § 48-16-203. The beginning point for Ms. White's personal liability is, of course, her personal guaranty of the corporate debt, which contained a specific guaranty that the corporate obligation to SecurAmerica would be performed in accordance with the loan agreement.

That guaranty is bolstered by her continued execution of amendments to the original loan, with the third, fourth and fifth amendments taking place in 2000, the year that she was informed by Mr. Zakarian of the discrepancy in the books. Since she was a personal guarantor of the corporate debt, which increased in maximum limit with each amendment, she should have been aware that Mr. Zakarian's manipulation of the accounts exposed her to personal risk. The Court finds that her knowledge, at the point she was informed, imparted a duty to inform the lender, as well as a duty to herself to limit her personal liability.

Under Tennessee law, concealment or nondisclosure of a material fact constitutes fraud where there is a duty to disclose the information. *Hill v. John Banks Buick, Inc.,* 875 S.W.2d 667, 670 (Tenn. Ct. App. 1994), citing *Lonning v. Jim Walter Homes, Inc.,* 725 S.W.2d 682, 685 (Tenn. Ct. App. 1986); *Macon County Livestock Market, Inc. v. Kentucky State Bank, Inc.,* 724 S.W.2d 343, 349 (Tenn. Ct. App. 1987)(citations omitted). Further, "[t]he fact or condition must materially affect the agreement." *Hill*, 875 S.W.2d at 670. Since Ms. White's personal guaranty obligated her to assure that the corporation complied with the loan agreement, as modified, any knowledge she gained about possible misrepresentations in the books was material to the agreement between Premier and SecurAmerica.

In a frequently cited case, the Tennessee Supreme Court set forth three circumstances under

which a duty to disclose exists. In *Domestic Sewing Machine Co. v. Jackson,* 83 Tenn. 418, 424-25 (1885), the Court stated:

> In all cases, concealment or failure to disclose becomes fraudulent only when it is the duty of a party having knowledge of the facts to discover them to the other party: 2 Pom Eq., sec. 902. And this author, in the same section, said: "All the instances in which the duty to disclose exists and in which a concealment is therefore fraudulent, may be reduced to three distinct classes:
> 1. Where there is a previous definite fiduciary relation between the parties.
> 2. Where it appears one or each of the parties to the contract expressly reposes a trust and confidence in the other.
> 3. Where the contract or transaction is intrinsically fiduciary and calls for perfect good faith. The contract of insurance is an example of this last class."

More recently, courts have elaborated that "[a] party to a contract has a duty to disclose to the other party any material fact affecting the essence of the subject matter of the contract, unless ordinary diligence would have revealed the undisclosed fact," *Lonning v. Jim Walter Homes, Inc.,* 725 S.W.2d 682, 685 (Tenn. Ct. App. 1987)(citation omitted), and "[f]or concealment to constitute fraud, there must be a suppression of material facts that one party was legally or equitably obligated to communicate." *Cherry v. Williams,* 36 S.W.3d 78, 85 (Tenn. Ct. App. 2000). Again, Ms. White's personal guaranty carried with it an obligation to assure compliance by Premier with the loan agreement; thus, she was legally and equitably obligated to communicate any knowledge she had to SecurAmerica.

In summary, the Debtor was under contract with SecurAmerica by virtue of her guaranty of the corporation's debt and obligations, and she had a duty to disclose to SecurAmerica her knowledge of the inflated accounting records. Even though she may not have understood the full impact of what Mr. Zakarian had done, she obviously knew something was amiss, since she told him

to "get it right." Getting it right included her obligation to inform SecurAmerica of her knowledge, no matter how limited it might have been. Such an alert to SecurAmerica would have permitted the lender to discover the problem much earlier and to limit its loss. The Court concludes that Ms. White had a duty under her contract with SecurAmerica and under Tennessee law, and that her failure to disclose the information constitutes actual fraud under Tennessee law, therefore rendering some part of the debt to SecurAmerica nondischargeable under § 523(a)(2)(A). The question of how much of the debt is excepted from discharge will be discussed later in this opinion.

Although it is unnecessary to explore the other grounds for exception from discharge, the Court concludes that SecurAmerica's allegations under §523(a)(4) are without merit under the facts and circumstances existing in this case. Section 523(a)(4) excepts debts from discharge that, among other things inapplicable here, result from fraud or defalcation while acting in a fiduciary capacity. Even though the Debtor was an officer of the corporation, she did not specifically place herself in a fiduciary relationship with SecurAmerica for purposes of § 523(a)(4) merely by guaranteeing the corporation's debt. Section 523(a)(4) applies only to express or technical trusts, and does not extend to implied trusts. *See Carlisle Cashway, Inc. v. Johnson (In re Johnson),* 691 F.2d 249 (6th Cir. 1982). There was no proof that the guaranty in this case established an express trust.

The Court also concludes that the Debtor's counter-complaint seeking damages for SecurAmerica's willful and malicious violation of the automatic stay is without merit. "To recover damages under § 362(h), the debtor must prove (1) that the violation of the stay was 'willful'; and (2) that the individual seeking damages was actually injured by the violation of the stay." *United States v. Mathews (In re Mathews),* 209 B.R. 218, 220 (B.A.P. 6th Cir. 1997). The Debtor alleges that representatives of SecurAmerica made three brief telephone calls to her in an attempt to arrange

a meeting to discuss repayment of the corporation's debt. Representatives of SecurAmerica contend that the telephone calls were to seek the Debtor's assistance in the liquidation of the corporation's assets, which was apparently taking place at the time of the calls. The Debtor presented no evidence of any actual injury suffered as a result of any stay violation resulting from the telephone calls, and the proof is clear that when Ms. White told the callers that they must speak with her bankruptcy attorney, the calls stopped. Because Ms. White was the person in charge of sales, SecurAmerica logically wanted her help in analyzing and collecting the accounts receivable. The proof did not persuade the Court that SecurAmerica's representatives made the calls with the intent to collect from Ms. White personally. In the absence of proof of damages and insufficient proof of a violation of the automatic stay, therefore, the counter-complaint for damages is denied.

MONEY DAMAGES

Having found and concluded that a debt to SecurAmerica is excepted from discharge under 11 U.S.C. § 523(a)(2)(A), the question is how much debt. The Plaintiff obviously seeks a judgment for its remaining unsecured debt, approximately $800,000, notwithstanding that it reached a consensual agreement with Mr. Zakarian for a nondischargeable judgment of $100,000. The parties did not address in their post-trial briefs the justification for an amount. Of course, the Debtor took the position that all of the debt should be discharged. The Court, sua sponte, questions the amount, since the preface to § 523(a)(2) says that money or an extension of credit is excepted from discharge for fraud, but only "to the extent obtained, by" fraud. Since the Court has found Ms. White's nondischargeable liability to be based solely on her failure to communicate to SecurAmerica her knowledge of Mr. Zakarian's manipulation of the books, her fraud began at the point of her knowledge, which was at its earliest in June of 2000. It would appear, therefore, that the only debt

excepted from discharge would be the credit extended after she acquired her knowledge. There is no proof of that amount; although, it would appear to be relatively small compared to the total debt. Unless the parties can reach an agreement on the amount of debt excepted from discharge, further proof will be needed.

CONCLUSION

For the reasons set forth above, the Court finds that a part of Premier's obligation to SecurAmerica is nondischargeable as incurred through the Debtor's fraudulent concealment of material facts under § 523(a)(2)(A), and that the Debtor's counter-complaint for damages for SecurAmerica's alleged willful violation of the automatic stay is without merit and is therefore denied. However, the amount of the debt to be excepted from discharge is unknown to the Court, and further proof will be needed, unless the parties can reach an agreement on that amount.

A final order will not be entered at this time, since the amount of the judgment is not determined. An evidentiary hearing on damages will be held on a date to be determined; however, the Court wishes to give the parties an opportunity to agree upon the amount of debt to be excepted from discharge. Should the parties be able to agree, an order consistent with this opinion and setting the amount of judgment shall be prepared by the attorney for SecurAmerica. Should such an order not be entered within thirty (30) days of this opinion's entry, the Court will set an evidentiary hearing on damages.

This the 28th day of October, 2003.

William Houston Brown
United States Bankruptcy Judge

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