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JUDGE: M. A. Mahoney
PARTIES: Virgil E. McCullough, Rhonda V. McCullough, Cleo L. Andrews
CHAPTER: 7
ATTORNEYS: L. C. Williams, M. E. Wynne
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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF ALABAMA

In Re

VIRGIL E. McCULLOUGH and
RHONDA V. McCULLOUGH

Case No. 98-10861-MAM-7

Debtors.

CLEO L. ANDREWS

Plaintiff,

v.

Adversary No. 98-1097

VIRGIL E. McCULLOUGH

Defendant.

ORDER DENYING PLAINTIFF RELIEF FROM STAY AND ORDER AND JUDGMENT FINDING DEBT TO BE DISCHARGEABLE AND AWARDING DEBTOR A DISCHARGE

Lionel C. Williams, Mobile, Alabama, for the Defendant
Marion E. Wynne, Mobile, Alabama, for Plaintiff

This matter came before the court for trial on September 22, 1998. This court has jurisdiction to hear this matter pursuant to 28 U.S.C. § § 1334 and 157 and the Order of Reference of the District Court. This is a core proceeding pursuant to 28 U.S.C. § 157(b) and the court has the authority to enter a final order. For the reasons indicated below, this court finds that the debt owed by Virgil E. McCullough to Cleo L. Andrews is dischargeable pursuant to 11 U.S.C. § § 523(a)(4) and 523(a)(6), the debtor is granted a discharge under 11 U.S.C. § 727, and the motion for relief from stay of Cleo L. Andrews is denied.

FACTS

A.

In February 1984 Virgil E. McCullough (debtor) started a bait and tackle business located at 1675 Battleship Parkway, Mobile, Alabama. Sometime in 1985, debtor incorporated the business under the name Mack's Bait and Tackle, Inc. ("the corporation" or "the business"). For the most part of the next twelve years, debtor and his wife, Rhonda V. McCullough, operated the business.

Debtor leased the premises on which the business was located from the state of Alabama. In June 1995 debtor's lease expired and the state put the land up for sale by public bid. Debtor could not afford to make a competitive bid so he decided to move the business to 3908 Battleship Parkway, Mobile, Alabama. However, he needed financial assistance to make the move.

On December 11, 1996, debtor and Cleo L. Andrews (plaintiff) executed two promissory notes in which plaintiff loaned the corporation a total of $65,000 (one note was for $50,000 and the other was for $15,000). On the same date, debtor, plaintiff, and Gary McNeely executed a Memorandum of Understandings (corporate bylaws) in which debtor retained a 48.5% share in the corporation, plaintiff received a 48.5% share and McNeely received a 3% share. The corporate bylaws stated that the proceeds of plaintiff's loan were only to be used "for lease-hold improvements" at the new business location. These proceeds enabled the business to move to 3908 Battleship Parkway in February 1997.

The corporate bylaws provided that debtor would receive a salary of $3,000/month, plaintiff $1,500/month, and McNeely $1,120/month. Plaintiff testified that he orally agreed not to receive any salary until the business became profitable at its new location. Debtor never received his salary either, although he admitted using corporate checks to pay for certain personal expenses, including payment for a truck used by his daughter and payment of at least one bill she owed to Faulkner State Community College. Debtor also used corporate funds to make payments on a second mortgage on his home and a line of credit available through Mack's Chase Advantage Card, but he testified at trial that both of these loans were obtained to pay for expenses of the business, not personal expenses. Debtor and his wife also ordered food and household items through the business for which they did not pay. According to plaintiff's exhibits, from May 14, 1997 through June 10, 1997 the business paid $1,834.88 in personal bills. The business also made five payments on plaintiff's loan totaling about $5,000.

Due at least in part to its relocation in February 1997, Mack's struggled to meet its obligations, let alone make a profit. Between February and June 1997, John Robinson, a patron of Mack's, noticed that the business had few supplies and after questioning debtor, he learned about the dire financial condition of the business. Robinson told debtor that he would "take over" the business and try to help debtor make it prosperous again on one condition: plaintiff could no longer be involved in the operation of the business. Plaintiff offered to sell his share back to the corporation for $71,000, but his offer was rejected. Debtor turned the business operations over to Robinson in June 1997. Robinson paid nothing, but he also was given no ownership rights.

While Robinson operated the business, he made numerous improvements, including purchasing and installing an air conditioner, an electric cash register, and a credit card machine, stocking the business with supplies, installing a boat slip and paving an exterior portion for use as a patio. Robinson changed the name of the corporation's restaurant to Delta Bar & Grill. He did not ask for or receive anything in return for his efforts. Robinson's "takeover" was at no cost to the corporation or its shareholders.

On April 14, 1997, plaintiff resigned from any and all offices he held within the corporation, but he did not relinquish any of his stock in the corporation. In May or June 1997, plaintiff took all of the corporate books, apparently to ascertain how much Mack's was making, where these revenues were being spent, and why he only received five payments on his notes. According to Plaintiff's Exhibit 23 which he prepared from the records he reviewed, the corporation's monthly gross revenue averaged $28,457.75/month in 1994, and $24,976.33/month in 1995. The corporation grossed $11,463.55 in March 1997, $19,614.60 in April 1997, and $20,619.81 in May 1997 (average of $21,053.84/month during these three months or the time period during which the business operated at its new location). Plaintiff did not offer adequate evidence for this court to determine the corporation's net revenue or profits after its move, but the debtor/defendant credibly testified that the business was not making enough money to survive.

Sometime in the summer of 1998, the Circuit Court of Baldwin County in case number CV97-1151 awarded plaintiff full ownership of the corporation. Plaintiff has run the business since that time, while debtor currently works for Atlantic Marine as a welder.[1]

B.

Debtor testified that in 1994 he and his wife purchased property described as Lot 1 and 2 in Block 29 in River Park Fruit Company Subdivision from his father-in-law for $15,000 (the

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[1] According to plaintiff's counsel, the business was severely damaged in late September 1998 when Hurricane Georges hit southern Alabama. The court is unsure how the storm may have affected the assets or operations of the business.

property). On January 2, 1995, debtor's father-in-law loaned $20,000 to debtor and his wife without collateral. About June of 1996, debtor and his wife realized they would be unable to repay their father in cash, so they transferred the property back to their father in payment of the $20,000 debt. Plaintiff and debtor dispute when the deed to the property was signed. It was signed by debtor and his wife on either June 19, 1996 or 1997 according to the deed. The deed was notarized on June 19, 1996 and filed in the Baldwin County Probate Court on July 1, 1997. This property and its transfer to debtor's father-in-law was not included in debtor's chapter 7 schedules or in his Statement of Financial Affairs.

Debtor filed a chapter 7 bankruptcy case on March 9, 1998. Plaintiff filed this adversary proceeding in response.

LAW

Plaintiff seeks to have debtor's debt arising from the promissory notes executed on December 11, 1996 declared nondischargeable pursuant to 11 U.S.C. § § 523(a)(4) and 523(a)(6). It is plaintiff's burden to prove his claims under § § 523(a)(4) and 523(a)(6) by a preponderance of the evidence. *Grogan v. Garner*, 498 U.S. 279, 11 S.Ct. 654, 112 L.Ed.2d 755 (1991).

Plaintiff also contends that debtor should be denied a discharge pursuant to 11 U.S.C. § § 727(a)(2)(A) and 727(a)(4). Based on the remedial purpose of discharge in bankruptcy, these provisions must be liberally construed in favor of debtor and against persons like plaintiff challenging debtor's right to discharge under the Bankruptcy Code. *Kriseman v. Ingersoll* (*In re Ingersoll*), 106 B.R. 287, 292 (Bankr.M.D.Fla.1989), *aff'd* 124 B.R. 116 (M.D.Fla.1991). Under § 727, plaintiff is required prove that debtor's discharge should be denied by a preponderance of the evidence. *Stone v. Bosse* (*In re Bosse*), 200 B.R.419, 421 (Bankr.S.D.Fla. 1996); *Barclays/Am. Business Credit, Inc. v. Adams*, 171 B.R. 298 (Bankr.W.D.Tenn. 1992), *aff'd* 31 F.3d 389 (6th Cir.1994), *cert. denied* 513 U.S. 1111, 115 S.Ct. 903, 130 L.Ed.2d 786 (1995).

A.

A debt for "fraud or defalcation while acting in a fiduciary capacity" is nondischargeable under 11 U.S.C. § 523(a)(4). Two elements must be present: (1) fraud or defalcation by the debtor (2) while he or she is acting as a fiduciary. *Freeman v. Frick* (*In re Frick*), 207 B.R. 731, 734 (Bankr.N.D.Fla.1997).

The courts have taken two different approaches in analyzing § 523(a)(4). The "trustee" or "fiduciary theory" limits the term "fiduciary" by requiring the existence of an express or technical trust. *Quaif v. Johnson*, 4 F.3d 950, 952 (11th Cir.1993); *Mid American Distribution Centers, Inc., v. Cato* (*In re Cato*), 218 B.R. 987, 991 (Bankr.M.D.Fla.1998). Cases adhering to this view often combine their strict definition of fiduciary with a broad definition of "defalcation" in which a defalcation may be an innocent default "so as to include all fiduciaries who for any reason were short in their accounts." *Frick*, 207 B.R. at 734-35 (cite omitted).

A second view defines "fiduciary" broadly, while using a narrow definition of "defalcation." This "defalcation theory" was explained by the Seventh Circuit *In Matter of Marchiando*, 13 F.3d 1111 (7th Cir.1994). The court in *Marchiando* decided that a fiduciary relationship required the existence of a duty to another before the wrong occurred and "a difference in knowledge or power between fiduciary and principal." *Id.* at 1116. In a subsequent decision, the Seventh Circuit concluded that a defalcation required a willful, reckless, or knowing breach, as opposed to a "mere negligent breach," of a fiduciary duty. *Meyer v. Rigdon*, 36 F.3d 1375, 1385 (7th Cir.1994).

This court will not determine in this case which interpretation of § 523(a)(4) binds it because plaintiff's debt is nondischargeable under either interpretation. Under the "fiduciary" or "trustee theory," the debt is dischargeable whether the relationship between debtor and plaintiff is characterized as that of equal stockholders (they each have a 48.5% stake in the corporation) or as corporate officer and creditor (based on the promissory notes executed by the parties in which debtor signed as president of the corporation without personally obligating himself). According to the "fiduciary" or "trustee theory," neither relationship of Andrews and McCullough qualifies as an express or technical trust or imposes upon the debtor the duty of a trustee. *Feldman v. Kaufman* (*In re Kaufman*), 85 B.R. 706, 710 (Bankr.S.D.N.Y.1988) (50% stockholder does not owe any specific duty to plaintiff merely because plaintiff was also 50% stockholder); *Farmers and Merchants Bank of Eatonton, Ga. v. Brinsfield* (*In Matter of Brinsfield*), 78 B.R. 364, 369 (Bankr.M.D.Ga.1987) (corporate president does not owe fiduciary duty to creditor).

If this court were bound to apply "the defalcation theory," the debt would still be dischargeable under § 523(a)(4). Debtor and plaintiff were equal shareholders in the corporation and there was no indication that debtor said or did anything that made it reasonable for plaintiff to believe that debtor was to treat his debt as if debtor were his fiduciary. Debtor was a welder by trade and plaintiff received a business degree upon graduating from college. Debtor has less sophistication then plaintiff in business matters. Debtor had no position of power over plaintiff. They were equals. Moreover, even if a fiduciary relationship existed, there was no defalcation while this relationship existed. Debtor and his wife tried to make the business work and repay plaintiff's loan, but the relocation made this difficult, if not impossible. Debtor testified that he used the loan proceeds to enable the business to change locations as the corporate bylaws required. Plaintiff never proved that debtor used any business proceeds inappropriately. Debtor paid a few personal bills, but there was no evidence that these sums were not part of his stated salary. Some of the bills he paid were for expenses he incurred for the business, i.e., the second mortgage and the Chase Advantage credit card.

Even assuming debtor was reckless in his duty as a fiduciary, plaintiff recouped any loss that he may have incurred. Plaintiff now has full ownership of the business and all of its assets. He also received the value of all of the improvements made by Robinson. Any damage caused by Hurricane Georges is irrelevant because it occurred after plaintiff was awarded the business by a state circuit court. Thus, even if defalcation is defined broadly to include all fiduciaries who are short in their accounts, there was no defalcation of debtor's duty because no loss was shown. Plaintiff did not prove that debtor used the loan or business proceeds inappropriately.

B.

A debt "for willful and malicious injury by the debtor to another entity or to the property of another entity" is nondischargeable under § 523(a)(6). In a recent decision, the United States Supreme Court held that § 523(a)(6) only excepts from discharge debts that arise from acts done with an actual intent to cause injury and not those that arise from recklessly or negligently inflicted injuries. *Kawaauhau v. Geiger*, 118 S.Ct. 974 (U.S. 1998). This court finds that the debt owed to plaintiff arose primarily because debtor had to relocate his business and incur expenses that the business could not meet. There was absolutely no evidence that debtor decided not to repay plaintiff with the intent to cause plaintiff injury. In fact, debtor made five payments on the loan.

C.

Under 11 U.S.C. § 727(a)(2)(A), the debtor's discharge should be denied if plaintiff proves the following elements: 1) that a transfer occurred; 2) that the property transferred was property of the estate; 3) that the transfer occurred within one year of the filing of the bankruptcy petition; and 4) that at the time of the transfer debtor intended to hinder, delay or defraud a creditor. *Ingersoll*, 106 B.R. at 292. Debtor contends that plaintiff has failed to prove elements three and four.

Debtor argues that he transferred the property to his father-in-law on June 19, 1996 when he signed the deed to the property and when the deed was notarized. If true, then the transfer did not occur within one year of the May 9, 1998 filing of debtor's bankruptcy petition as § 727(a)(2) requires for denial of discharge. Plaintiff claims that the deed was executed on June 19, 1997. He argues this is evidenced on the first page of the deed whereon the "6" in 1996 was stricken and replaced by a "7." Alternatively, plaintiff argues that the transfer did not occur until July 1, 1997 when the deed was filed for recordation.

In *Ingersoll*, the debtor quitclaimed property to his father in November 1985. The deed was not recorded until January 29, 1988, thirty-two days prior to the debtor filing his bankruptcy petition. In denying the debtor's discharge under § 727(a)(2), the court held that the transfer occurred when the deed was recorded, rather than in November 1985. The court decided that the alleged transfer in November 1985 was merely an "attempted" transfer because the debtor continued to use the property, to pay real estate taxes, and to claim a deduction for payment of real estate taxes. *Ingersoll*, 106 B.R. at 292. Unlike the debtor in *Ingersoll*, there is no evidence that McCullough used the property, paid taxes on the property or claimed a tax deduction for any expenses incurred on the property after June 19, 1996 when he claims to have transferred the property to his father-in-law. Post trial, plaintiff offered evidence of the property's tax records, but they were not admitted. Allegedly, these records showed that the property was in debtor's name for real estate tax purposes after June 19, 1996 and that debtor therefore paid the real estate taxes after that time. However, nothing offered indicated that debtor paid these taxes and even if he paid the taxes after June 19, 1996, this does not prove, by itself, that debtor used or received any benefit from the property after the pertinent date. In sum, nothing admitted into evidence indicates that the transfer did not occur when the deed was executed or that the transfer was not effective until the deed was recorded. The debtor and his wife's testimony as to the transfer was credible.

Plaintiff also failed to prove that the deed was executed on June 19, 1997, rather than 1996. The notary certified under seal that the deed was executed before him on June 19, 1996. In light of this evidence, the mere fact that the date above debtor's signature read 1996 with the "6" stricken and a "7" inserted does not provide sufficient evidence for this court to conclude by a preponderance of the evidence that debtor executed the deed on June 19, 1997, rather than 1996.

Even assuming the transfer occurred within one year of debtor's filing of his bankruptcy petition, plaintiff has not established that debtor possessed the requisite intent to hinder, delay or defraud a creditor. Plaintiff may use circumstantial evidence in proving this intent. *Harris v. Burrell* (*In the Matter of Burrell*), 159 B.R. 365, 372 (Bankr.M.D.Ga. 1993). Courts have developed "badges of fraud" to help determine if actual intent to defraud existed when the transfer occurred. *Id*. The badges of fraud include:

> 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;
> 5) the existence of a pattern 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.

First, debtor received adequate consideration in return for the property. In fact, it appears that debtor made money in his dealing with his father-in-law. He purchased the property for $15,000 and returned it to him in satisfaction of a $20,000 loan. Debtor testified that the property had little worth at the time of the transfer and the house located on it was dilapidated. Plaintiff offered no evidence to rebut the debtor's testimony regarding the value of the property. Second, plaintiff did not prove that debtor used the property after the transfer, regardless of when the transfer occurred. As discussed above, plaintiff failed to prove that debtor retained any benefit from the property after June 19, 1996. Third, debtor's financial demise resulted from the declining profits at his business, not from the transfer of the property. Fourth, there was no evidence of a pattern of suspicious conduct after the debt was incurred. Fifth, the chronology of events is not indicative of an intent to defraud. Debtor testified that he signed the deed when he realized he could not repay his father-in-law's loan. This may show that debtor made the transfer after he was insolvent or on the verge of insolvency, but it does not show an intent to defraud his creditors. The only indicia of an intent to defraud creditors is the fact that debtor is the son-in-law of the transferee. This sole factor considered in light of all of the facts presented is not sufficient to find that debtor intended to hinder, delay or defraud plaintiff.

D.

Question 10 of debtor's Statement of Financial Affairs requires him to list property transferred within one year of his filing for bankruptcy and to swear, under penalty of perjury, that his answers are true to the best of his knowledge, information, and belief. Plaintiff argues that debtor knowingly and fraudulently made a false oath or account when he did not include the transfer of the property to his father-in-law in his answer to Question 10 and therefore, debtor's discharge should be denied pursuant to 11 U.S.C. § 727(a)(4)(A).

It would be reasonable to believe that the transfer of the property occurred on June 19, 1996, June 19, 1997, or July 1, 1997 (see discussion in Part C.). If the transfer occurred in 1996, then debtor's answer would not be false. If the transfer took place on either June 19, 1997 or July 1, 1997, then debtor's answer would be false. However, plaintiff must prove that debtor knowingly and fraudulently made this false answer. Assuming the transfer should have been included in debtor's answer to Question 10, there is no evidence that debtor intended to deceive its creditors in neglecting to disclose it. Instead, the testimony of debtor and his wife indicates that they believed that they transferred the property in 1996 and consequently, that it was not necessary to disclose the transfer. *MacLoed v. Arcuri* (*In re Arcuri*), 116 B.R. 873 (Bankr.S.D.N.Y.1990) (when mistake occurs in unclear area of law, requisite fraudulent intent is not established). The court observed debtor and his wife and found their testimony to be credible. Therefore, even if debtor's answer to Question 10 was false, it was not made "knowingly or fraudulently." Accordingly, debtor's discharge is not denied under § 727(a)(4)(A).

E.

Plaintiff moved this court for relief from the automatic stay to pursue his remedies against debtor in state court. Pursuant to 11 U.S.C. § 362(d)(1), relief should be granted if there is cause. This court has dealt with many of these issues involving debtor's debt to plaintiff in this opinion. To the extent any issue remains as to the priority extent or amount of the debt, it can be dealt with most expeditiously in a claim objection. This court is now very familiar with the facts. Since the court is concluding that the debt is dischargeable pursuant to 11 U.S.C. § 523 and debtor is entitled to a discharge under 11 U.S.C. § 727, it would be inappropriate to lift the stay to allow any collection outside the bankruptcy estate. Therefore, relief from stay is denied.

THEREFORE IT IS ORDERED AND ADJUDGED that Virgil E. McCullough's debt to Cleo L. Andrews based upon the promissory notes of December 11, 1996 is DISCHARGED and Virgil and Rhonda McCullough are granted a DISCHARGE under 11 U.S.C. § 727 and the motion for relief from stay of Cleo L. Andrews is DENIED.

Dated: October 23, 1998

MARGARET A. MAHONEY
CHIEF BANKRUPTCY JUDGE