SO ORDERED.

SIGNED this 01 day of March, 2005.

Dale L. Somers

Dale L. Somers
UNITED STATES BANKRUPTCY JUDGE

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS

In Re: **BARBARA D.W. HECK,** **DEBTOR.**	**CASE NO. 03-21569-7** **CHAPTER 7**
U.S. BANK, **PLAINTIFF,** **v.** **BARBARA D.W. HECK,** **DEFENDANT.**	**ADV. NO. 03-6107**

MEMORANDUM OF DECISION

This proceeding is before the Court for decision following a trial on the merits. Plaintiff U.S. Bank ("the Bank") appears by counsel Mark A. Shaiken. Defendant-debtor

Barbara D.W. Heck appears by counsel Cynthia F. Grimes. The Court has heard the evidence, reviewed the relevant pleadings, and is now ready to rule.

The Bank contends the Debtor's obligation to it based on her guarantee of a loan it made to her limited liability company ("the Company") should be excepted from discharge, pursuant to 11 U.S.C.A. § 523(a)(6), as a debt "for willful and malicious injury" to the Bank or its property. The loan was secured by the Company's inventory, but when the Debtor sold off the inventory and shut down the Company's business, she used almost all the proceeds to pay the Company's suppliers, other creditors, employees, and herself, rather than the Bank, and continued thereafter to work on her own in the same kind of business, dealing with some of the same suppliers. After carefully considering the evidence, the Court concludes that the Debtor's obligation to the Bank must be excepted from her discharge.

FINDINGS OF FACT

The Debtor owned or co-owned one or more businesses in the 1980's that had banking relationships with the Bank's predecessors. Because none of the issues raised concern the changes in the Bank's name, ownership, or structure, the Court will hereafter use "the Bank" to refer not only to the Bank but also to all the predecessor entities that dealt with the Debtor and her businesses over the years. Around 1990, the Debtor formed the Company, a limited liability company through which she did interior design work. She owned all interests in the Company, and operated it for many years out of her home. The Company also maintained a banking relationship with the Bank.

In 1999, the Company opened a retail store where it sold household furnishings, such as sofas, chairs, lamps, and pictures. During the relevant time, the Debtor determined who the Company would order inventory from and which debts it would pay with any money it obtained. Although the Debtor explained that she did interior design work for customers, nothing in the evidence indicated that the Company ever charged anyone directly for design services. Instead, the Company generated all its revenue through the difference between the wholesale prices it paid for products and the retail prices it sold them for. When customers wanted to buy something that was not already in the store, the Debtor required them to make a down payment more or less equal to the wholesale price of the item before she would order it, and to pay the balance of the retail price before the Company would deliver it. Consequently, outstanding accounts receivable would never have been a significant asset of the Company. Given the kind of store it operated, the Company would not have had much equipment, either. Instead, the only significant asset it would have had at any time (other than any good will it had generated) was its inventory.

When it opened the store, the Company obtained a $50,000 line of credit from the Bank to finance its inventory. This one-year loan was secured by several types of property, but the inventory was the only important type. The Court is convinced the Debtor knew the inventory was essentially the only asset the Company had pledged to secure the line of credit. The Debtor also personally guaranteed the debt, and gave the Bank a second mortgage of $23,500 on her home to secure the guarantee. Over the next few years, the loan was renewed annually, and the amount of the line of credit was increased. At the last renewal in April 2002, the amount was raised to $100,000. During these years, the Company made monthly interest payments to the Bank.

In September 2001, the Debtor refinanced the first mortgage on her home, giving the Bank a lien to secure a fifteen-year, $148,000 mortgage. By March 2003, the Debtor had reduced the balance on this mortgage to about $139,000. In February 2003, the Debtor got engaged to be married, and moved in with her fiancé. That same month, she listed her house for sale with a realtor. The asking price was $188,500.

In 2002, James Lowe, a senior vice president, became the Bank's officer in charge of the Company's loan. He had a get-acquainted lunch with the Debtor in July or August that year. Late in 2002 or early in 2003, the Debtor told Lowe that she had done an informal inventory after the Company's Christmas season and determined that there was about $300,000 worth of inventory in the store. This figure came from the Company's paper records of the cost of its inventory. In January 2003, the Debtor had the Company perform a physical inventory of the store, which found that only about $150,000 worth of merchandise, valued at cost, was actually there. In a deposition, the Debtor explained that most of the discrepancy had occurred because items that had been sold did not get removed from the inventory records; she thought only a small portion of it could have resulted from thefts. The Debtor knew that the discrepancy was a problem, and decided to have a big sale to try to get rid of old inventory. She never informed Lowe about the results of the physical inventory.

The Company began a sale of much of its inventory in January or February 2003. A competitor was having a sale at the same time, and its newspaper ad ran right beside the Company's. Presumably, this fact did not help the Company's sale succeed. From this time on, the Debtor ordered very little new inventory, and began cancelling many orders she had placed. Initially, the Debtor did not intend for the Company to go out of business, although she was considering the possibility; by no later than the middle of March, she had decided that it would. At that time, she bought a large going-out-of-business sign and put it in the store window. A short time later, she learned that the Company needed a city permit to have such a sale, so she got one. The sale ended in April, when the Debtor closed the Company's store and stopped doing business under its name. The store was last open on April 12, 2003.

During 2003, the Debtor used two bank accounts for the Company, one at the Bank and the other at the Lawrence Bank. From February 17 to April 14, over $175,000 in receipts from the sale of the store's inventory were deposited in the accounts,[1] with almost $2 going to the account at the Lawrence Bank for every $1 going to the one at the Bank. Nearly all of the inventory had been sold by the time the store closed. After shutting down

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[1]Plaintiff's Exhibit 2 is a copy of the Debtor's check register for one of the accounts. The pages included in the exhibit show over $170,000 in deposits, but comparing the running balance at the bottom of the tenth page of the exhibit to that at the top of the eleventh page reveals that one page of the register is missing and that at least $5,000 in additional deposits would have been recorded on that page. In addition, a review of the entries on the tenth and eleventh pages indicates that the deposit of cash sales receipts for April 2 and 3, 2003 (a Tuesday and Wednesday), would have been recorded there, along with checks numbered from 8966 through 8970, which would have included at least one pay check written on April 1. Consequently, the Court has added $5,000 to the deposits directly shown on the register, because at least that much would have been revealed by the missing page.

the Company, the Debtor continued to do interior design work out of her home, and continued to deposit receipts into one of the bank accounts. The Court reviewed the check registers the Debtor maintained for the two accounts and, to the extent the Court could identify which items were current operating expenses, determined that during this period, the Company paid between $35,000 and $39,000 in payroll, taxes, rent, utilities, advertising, and insurance, and about $11,360 in principal and interest to the Bank. The Debtor took out $14,400 for herself. So it appears the Company paid at least $110,000 to its suppliers during this time. The Court notes that the check registers are neat and well-maintained, offering no evidence that the Debtor had any trouble with addition or subtraction.

The Debtor claims that as of mid-March 2003, she thought she would be able to pay the Company's suppliers in full with the proceeds from the sale of the inventory, and pay the Company's debt to the Bank with the proceeds from the sale of her house. So by this time, the Debtor was aware that the inventory sale would not produce enough money to pay both her suppliers and the Bank. Even though (1) the Company had drawn out the full $100,000 line of credit from the Bank, (2) she still owed around $139,000 on the recently-refinanced first mortgage on her house, (3) she had listed the house with a realtor, who she knew would charge a commission, and (4) the asking price was only $188,500, the Debtor asks the Court to believe that she somehow thought the proceeds from the sale of the house could not only pay off the first mortgage on it, but also pay off the line of credit and leave her enough money to make a down payment on another house.

Because the Company's line of credit was due to be renewed in April 2003, Lowe contacted the Debtor sometime in January or February to tell her she would need to provide updated financial information to the Bank. He spoke with her several times over the next two or three months. Along the way, he learned about her engagement. After seeing an ad in the newspaper for a February 17 to March 1 sale at the store, Lowe called the Debtor and asked about her business plans. She told him she was thinking about selling the business and had someone who might be interested. He insists he told her then that the inventory was the Bank's collateral and the Bank expected to be paid from the inventory proceeds. Finally, in a March conversation, the Debtor told Lowe any potential sale of the business had fallen through and the Company was conducting a going-out-of-business sale.

The Debtor concedes that sometime in mid- to late-March, when Lowe mentioned that the Bank was not being paid with the going-out-of-business sale proceeds as he had expected and asked how she intended to repay the Bank's loan to the Company, she told him that she planned to pay the Bank with the proceeds of the sale of her home. He says he told her the Bank was looking first to the inventory and receivables as the source of payment for the line of credit. After that conversation, Lowe checked the balance on the Debtor's home mortgage and the county's appraised value for the home, and called her back within a couple of days to point out that after paying the sale costs and the first mortgage, the remaining proceeds from the sale of the home would not be sufficient to pay the Company's loan. She uttered an expletive she might have used either because she suddenly became aware her plan could not work, or because she was actually pursuing a different, improper scheme she feared had been exposed. She told Lowe that she and her fiancé would pay the Bank somehow. Lowe testified that in these March or early April conversations, he told the Debtor that the Bank still expected to be paid with the proceeds of the Company's inventory. Lowe admits he never sent the Debtor any written confirmation of this expectation, and she alleges she never understood that was the Bank's view.

Either shortly before or shortly after the expletive conversation, the Debtor wrote a Company check on April 3 to pay $10,000 on its debt to the Bank, but otherwise, the Company made only its normal interest payments on the debt while selling off the inventory. The Debtor paid operating expenses such as employee wages, taxes, utilities, and so forth, but used much of the inventory proceeds to pay the Company's suppliers. As indicated, after closing down the Company's business, she continued to do interior design work from her home, helping some of the same customers and buying furnishings from some of the same suppliers that the Company had dealt with.

The Debtor filed a Chapter 7 bankruptcy petition on April 22, 2003. In her schedules, she listed over $202,000 in unsecured debt, all but $700 of which she described as business debt. This included the $90,000 or so that she owed as a result of her personal guaranty of the Company's debt to the Bank. Most, if not all, of the $112,000 owed to other creditors appears to be credit card debt. Of the $111,300 in business debts, the Debtor reported that the Company was a co-debtor on all but one $10,000 debt to Discover. The Debtor testified that the Company had some suppliers who did not get paid from the inventory proceeds, but they were not listed on her bankruptcy schedules because she was not personally liable to them. According to Lowe, on the day the Debtor filed for bankruptcy, the Company's debt to the Bank was $91,612.89.

DISCUSSION

The Bank contends the Debtor's obligation to it is covered by § 523(a)(6), which excepts from discharge any debt a debtor owes "for willful and malicious injury . . . to another . . . or to the property of another. . . ." The Bank must prove by a preponderance of the evidence that the obligation satisfies this provision.[2] In *Kawaauhau v. Geiger*, the Supreme Court ruled that § 523(a)(6) applies only to a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury.[3] The Court explained that this means the debtor must have intended the consequences of the act he or she performed, not simply the act itself.[4]

The Tenth Circuit recently issued its first published post-*Geiger* decision addressing § 523(a)(6), *Panalis v. Moore (In re Moore)*.[5] The Circuit declared that both a "willful" act and a "malicious injury" must be proven to make a debt nondischargeable under this provision.[6] Then the court referred to a Tenth Circuit Bankruptcy Appellate Panel decision that had held for an act to be willful under § 523(a)(6), "the debtor must 'desire . . .

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[2] *Holaday v. Seay (In re Seay)*, 215 B.R. 780, 785 (10th Cir. BAP 1997).

[3] 523 U.S. 57, 60-64 (1998).

[4] 523 U.S. at 61-62.

[5] 357 F.3d 1125 (10th Cir. 2004).

[6] *Id*. at 1129.

[to cause] the consequences of his act or . . . believe [that] the consequences are substantially certain to result from it,"[7] and to an Eleventh Circuit decision that had held the term "malicious" required proof "that the debtor either intend the resulting injury or intentionally take action that is substantially certain to cause the injury."[8] This Court has some difficulty perceiving a substantive distinction between these definitions, but is convinced that their impact on this case is clear enough: to find that the Debtor's obligation to the Bank is nondischargeable, the Court must find at least that the Debtor believed that her failure to apply the proceeds of the Company's sale of its inventory to its debt to the Bank was substantially certain to injure the Bank or the Bank's property.

It is fairly common in bankruptcy cases for secured creditors to contend that the debts owed to them should be nondischargeable under § 523(a)(6) because their debtors improperly transferred their collateral without turning over to them any proceeds received; that is, the creditors allege the debtors converted the collateral. In one such case, *Mitsubishi Motors Credit of America, Inc., v. Longley (In re Longley)* — the Tenth Circuit BAP decision quoted in *Moore* — the BAP reviewed several Tenth Circuit decisions that pre-dated *Geiger* and considered *Geiger*'s effect on them.[9] The BAP concluded *Geiger* had reaffirmed that conversion of collateral can give rise to a nondischargeable debt, but

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[7] *Id*. at 1129 (quoting *Mitsubishi Motors Credit of America, Inc., v. Longley (In re Longley)*, 235 B.R. 651, 657 (10th Cir. BAP 1999), which was quoting *Restatement (Second) of Torts*, § 8A (1965)).

[8] *Id*. (quoting *Hope v. Walker (In re Walker)*, 48 F.3d 1161, 1164 (11th Cir. 1995).

[9] 235 B.R. at 654-57.

that the circumstances in a specific case could show that the conversion was done without willfulness or malice so the debt would be dischargeable.[10] The BAP went on to say:

> In light of *Geiger*, the standard for willful under § 523(a)(6) appears to be the same for conversion as for any other injury; to be willful, the debtor must intend that conversion of the collateral injure the creditor or the creditor's lien interest. However, *Geiger* does not address the evidence by which intent to injure can be established. We believe that as to proof of intent to injure in the context of conversion of secured property, [the prior Tenth Circuit decisions] remain instructive. Intent may be established by either direct or indirect evidence. Willful injury may be established by direct evidence of specific intent to harm a creditor or the creditor's property. Willful injury may also be established indirectly by evidence of both the debtor's knowledge of the creditor's lien rights and the debtor's knowledge that the conduct will cause particularized injury.[11]

This discussion has guided the Court's analysis of the evidence in this case.

The Company's line of credit with the Bank helped it buy inventory for its store. Although other types of assets were also given as collateral for the loan, the Company's business was such that its inventory was always the only significant collateral that existed. As the person running the business and controlling the payment of its bills, the Debtor clearly knew that the inventory was essentially the only collateral the Company had for the loan. She also knew, of course, that her house served as additional collateral through her personal guarantee and the second mortgage, but by April 2002, that mortgage protected less than one-quarter of the Company's line of credit. For several years, while the Debtor believed the Company's inventory was continuing to build up, reaching $300,000 by late 2002, she probably thought the Bank's security interest in the inventory was well-protected.

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[10] *Id*. at 657.

[11] *Id*. at 657 (citations after each of the last three sentences omitted).

But that all changed in January 2003 when the physical count of the inventory told the Debtor that only $150,000 worth was actually in the store. Even if she did not immediately recognize that the discrepancy threatened the Bank's security interest, the Court is convinced that Lowe did remind her several times of the Bank's claim against the inventory and its right to be paid from the proceeds of the sale of the inventory, thus alerting her to the need to protect the security interest. No doubt, the Debtor had good reason to panic, as she indicated she did: she knew the Company owed $100,000 to the Bank, she thought it owed about $75,000 to its suppliers, she presumably knew, as shown by her bankruptcy schedules, it owed another $100,000 or so on its credit cards, but now she knew the Company had much less inventory than she had previously thought. At trial, she testified that when the Company's sale began in February, she was not sure whether the inventory would bring enough to pay the suppliers and the Bank, but in an earlier deposition, she had said she recognized when the sale began that the Company could not generate enough money to pay both the suppliers and the Bank. Since the Company ultimately paid over $100,000 to its suppliers, its situation turned out to be even worse than she realized.

After discovering the inventory shortage, the Debtor continued to pay the Company's normal operating expenses, and decided to pay the balance of the inventory proceeds to the Company's suppliers. She began to reduce the Company's inventory by cancelling many inventory orders and placing few new ones. Even after she decided to sell off all the inventory in a going-out-of-business sale, she continued to use the sale proceeds to pay suppliers, and not the Bank. At the very latest, once she stopped using the sale proceeds to purchase new inventory, she had to know that the Bank's security interest in the Company's inventory would be destroyed to the extent she used the proceeds to pay other creditors.

The Debtor's claim to be an innocent, mathematically-challenged air-head who thought she could pay the Bank with the proceeds of the sale of her home was not convincing. The check registers suggest her math skills were far from deficient. Maybe she hoped she would pay some of the Company's debt to the Bank by selling her home, and could figure out some other way to pay the rest. But the Court is convinced she recognized that the Bank had a security interest in the inventory that was substantially certain to be injured by her decision to pay the suppliers, instead of the Bank, with the receipts from the sale. It is difficult to believe the Debtor did not know when she started the sale in February that her failure to honor the Bank's right to be paid from the inventory was substantially certain to injure the Bank's security interest. It is impossible to believe she did not realize this by mid-March when she made the firm decision to go out of business. It is clear to the Court that the Debtor decided to improve her chances to remain in the same business as a sole proprietor and to deal with the same suppliers after the Company's demise, in spite of her knowledge that her failure to honor the Bank's right to be paid from the inventory was substantially certain to injure the Bank's security interest in the inventory. Consequently, her debt to the Bank, based on her guarantee of the Company's $91,612.89 debt on its line of credit, will be excepted from her discharge, pursuant to § 523(a)(6).

The foregoing constitutes Findings of Fact and Conclusions of Law under Rule 7052 of the Federal Rules of Bankruptcy Procedure and Rule 52(a) of the Federal Rules of Civil Procedure. A judgment based on this ruling will be entered on a separate document as required by FRBP 9021 and FRCP 58.

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