SO ORDERED.

SIGNED this 26 day of July, 2005.

ROBERT E. NUGENT
UNITED STATES CHIEF BANKRUPTCY JUDGE

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS

IN RE:	)	
	)	
TERRY L. REED and,	)	**Case No. 04-11874**
CAROL R. REED,	)	**Chapter 7**
	)	
Debtors.	)	
	)	
CURTIS GILSDORF,	)	
	)	
Plaintiff,	)	
v.	)	**Adversary No. 04-5162**
	)	
TERRY L. REED,	)	
Defendant.	)	

MEMORANDUM OPINION

Curtis Gilsdorf seeks to except Terry Reed's debt to him from discharge. The nature and extent of that debt is more fully described below. Gilsdorf asserts in the alternative that Reed's debt to him arises

out of a breach of fiduciary duty or malicious damage to Gilsdorf's property interests under 11 U.S.C. § 523(a)(4) and (a)(6). This matter was tried to the Court on May 17, 2005. After receiving and carefully considering a number of documentary exhibits and the testimony of Messrs. Gilsdorf and Reed, the Court makes its findings of fact and conclusions of law in accordance with Fed. R. Civ. P. 52 and Fed. R. Bankr. P. 7052.

Jurisdiction

The Court has jurisdiction of this proceeding. 28 U.S.C. § 1334. This adversary proceeding is a core proceeding. 28 U.S.C. § 157 (b)(2)(I).

Findings of Fact

In 2001, Gilsdorf and one John Balthazor invested in defendant Terry Reed's business, known as Reed Sales and Service ("RSS"). RSS was incorporated on August 21, 2001 and Gilsdorf and Balthazor each received equal shares of its stock. Later that year, Reed and Gilsdorf executed a promissory note as RSS to the Beverly State Bank. Curiously, the note was made in the name of "Reed Sales and Service" and signed by both Reed and Gilsdorf without either an indication that RSS was a corporation or a designation that either Reed or Gilsdorf was signing in a representative capacity. Repayment of the note was secured by two specific pieces of machinery, a press shear and a press brake, as well as a Harley-Davidson motorcycle. The security agreement executed by Gilsdorf and Reed also contained a dragnet provision which granted a security interest in all of the other equipment and tools of RSS. Gilsdorf received the proceeds of this loan because he had previously paid to acquire the press brake and shear.

In April of 2003, RSS sold its Automotive Lift Division to Metal Tech Partners. Pursuant to a written agreement, $15,000 was to be paid each to Gilsdorf and Balthazor who, by this time, had tired of

the business and sought to have their capital stock redeemed. Metal Tech acquired the rights to produce the RSS "Toplift" equipment and agreed to pay RSS royalties for producing same. This transaction closed on May 9, 2003. On May 8, 2003, Gilsdorf, Balthazor and Reed signed a Settlement Agreement pursuant to which Gilsdorf and Balthazor agreed to surrender their stock for the $15,000 payments while Reed and RSS agreed to not sell any property that was collateral for any corporate debt that Gilsdorf or Reed had guarantied or cosigned without obtaining a lien release on same by satisfying the debt.

When RSS failed to make payments on the Beverly State Bank note, Gilsdorf acquired the note and security agreement after paying the Bank $29,482.12. These documents, as well as the Bank's financing statement were duly assigned to him. When RSS failed to repay the note, Gilsdorf commenced a lawsuit in Saline County District Court on December 2, 2003 seeking to foreclose his security interest under KAN. STAT. ANN. § 60-1006 (1994). Gilsdorf obtained a pre-judgment Order for Immediate Possession as provided for in KAN. STAT. ANN. § 60-1005 (1994) and the sheriff's office executed the Order, thereby facilitating Gilsdorf's possession of the press brake, the shear, and the motorcycle. In the course of the proceedings, Gilsdorf sold the brake and shear, but he remains in possession of the motorcycle. Prior to filing his lawsuit, Gilsdorf exercised self-help repossession with respect to other personal property that may or may not have been sold.

Reed filed his bankruptcy petition on April 12, 2004. The Saline County litigation continued against RSS until June of 2004 when the state court entered default judgment against RSS as a discovery sanction after RSS failed several times to produce Reed for a deposition. An appeal to the Kansas Court of Appeals was not properly perfected and was thereafter dismissed. Under the state court judgment, Gilsdorf's security interests were found to be senior liens on his collateral and foreclosed.

At some point in mid- to late 2003, Reed began to operate RSS as a sole proprietor with a separate bank account. He sold some of the RSS equipment in which Gilsdorf claimed a lien by virtue of his assigned note and security agreement, doing so without Gilsdorf's approval and without accounting to him for the proceeds. Reed testified that some of the sale proceeds went to pay debts of the company and others went into the corporate bank account and were presumably consumed in corporate operations. Reed also testified that he did business as a sole proprietorship known as RSS even while the corporation was valid. Reed was president and a director of the RSS corporation, but held no other position of trust with respect to Gilsdorf. Reed executed no documents that would have established a formal fiduciary arrangement or trust relationship with Gilsdorf.

The parties agree that the corporate status of RSS has lapsed because no franchise tax returns have been filed as required by the Kansas Corporation Code.[1] For the same reason, the corporation has not been statutorily dissolved.[2] Reed asserts that he cannot act to dissolve the corporation until he learns how Gilsdorf has disposed of the repossessed collateral. Reed concedes that he is in possession of a variety of tools and equipment that he says became "his" when the corporation lapsed. He considers that this property is not subject to Gilsdorf's lien, even though the state court judgment holds to the contrary. In his testimony, Reed estimates that the value of the tools and equipment he received and retains as a result of the lapse is about $20,000. It appears that he remains in possession of the following equipment: Milwaukee rechargeable drills, die grinders, miscellaneous reamers and drill bits, banding equipment, and impact tools. At the time Reed donated these items to the corporation in 2001, he valued them at

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[1] *See* KAN. STAT. ANN. § 17-7503 (Supp. 2003) and § 17-7510 (1995).

[2] *See* KAN. STAT. ANN. § 17-6806 (1995).

$2,005.00.

Reed admits to having sold the following equipment: 3 towmaster 8 x 16 trailers, Clark forklift, Esab welder, Miller welder, bandsaw, 1982 Chevy snow truck, 1983 Chevy snow truck, 2 snow blades, and an iron worker machine. These items are pricier, having been valued at $10,640 at the time of incorporation, exclusive of the iron worker machine. It is unclear how much Reed received as proceeds of the sale of these items. Likewise, it is unclear what amounts Gilsdorf received in liquidating that portion of the collateral he recovered.

Conclusions of Law

At the outset of the trial, Gilsdorf abandoned his previously-pled general objections to discharge under 11 U.S.C. §§ 727(a)(2) and (a)(7), focusing the remaining inquiry on whether Reed's conduct amounted to either fraud by a fiduciary or willful and malicious damage to Gilsdorf's property.

Fiduciary Fraud, § 523(a)(4)

Section 523(a)(4) excepts from discharge a debt arising out of a debtor's "fraud or defalcation while acting in a fiduciary capacity . . . ." Gilsdorf predicates Reed's fiduciary duty on Reed's having served as president of the moribund RSS.[3] Gilsdorf essentially asserts that when Reed failed to follow the

[3] Under Kansas law, officers and directors of a corporation owe a strict fiduciary duty to *the corporation and its stockholders*. When a shareholder believes that an officer or director has breached his fiduciary duty, the shareholder may file a derivative action. Only in very limited circumstances can a shareholder maintain an individual damage suit. In other words, the corporation is the party that may seek redress for breach of fiduciary duty. *See Richards v. Bryan*, 19 Kan. App. 2d 950, 879 P.2d 638 (1994); *In re Luna*, 406 F.3d 1192 (10th Cir. 2005). No fiduciary duty is owed by an officer or director to a corporation's creditors. *See Speer v. Dighton Grain, Inc.*, 229 Kan. 272, 624 P.2d 952 (1981).

statutory procedures for dissolving the corporation, he breached an implicit fiduciary duty to the corporation's creditors when he sold or retained for his own use property of the corporation and that this amounts to fraud while acting in a fiduciary capacity.

This argument is easily disposed of, however, because controlling Tenth Circuit precedent has long held that the fiduciary relationship required to establish a cause of action under § 523(a)(4) must be of a formal, not an implied, nature.[4] An express or technical trust is lacking between Gilsdorf and Reed. Rather, here, Gilsdorf occupies the position of a creditor, having succeeded to the Bank's note and security agreement. This does not satisfy the fiduciary relationship required for § 523(a)(4).[5]

Moreover, the fiduciary relationship required by § 523(a)(4) must be shown to exist prior to the creation of the debt in controversy.[6] The fraud must occur *while acting in a fiduciary capacity.*[7] Even if Reed can be said to have owed a fiduciary duty to Gilsdorf individually as a stockholder in RSS, Gilsdorf was no longer a shareholder in RSS by the time the state court judgment was entered and the debt was created. By this time, the settlement agreement had been entered into and Gilsdorf had been paid $15,000

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[4] *See Fowler Bros. v. Young (In re Young),* 91 F.3d 1367, 1371-72 (10th Cir. 1996) (An express or technical trust is required for a fiduciary relationship to exist under § 523(a)(4); neither a general fiduciary duty of confidence, trust, loyalty, and good faith nor inequality between parties' knowledge or bargaining power is sufficient); *In re Luna*, *supra.* (The relationship of debtor to creditor that results from contract is not fiduciary in nature; debtor-employers who owed unpaid monthly employer contributions to ERISA-covered employee benefit plan were not fiduciaries).

[5] *See Driggs v. Black (In re Black),* 787 F.2d 503, 506 (10th Cir. 1986), *overruled on other grounds by Grogan v. Garner*, 498 U.S. 279 (1991) (Defendant majority shareholder owed no fiduciary duty to creditor who was minority shareholder.).

[6] *In re Young*, 91 F. 3d at 1372.

[7] 11 U.S.C. § 523(a)(4).

for his stock buyout; Gilsdorf had purchased the Bank's note and held the status of a creditor and nothing more.

For the foregoing reasons, Gilsdorf has not proven a § 523(a)(4) exception to discharge.

Wilful and Malicious Injury, § 523(a)(6)

Section 523(a)(6) excepts from discharge debts arising out of the debtor's "wilful and malicious injury by the debtor . . . to the property of another." This section is frequently relied upon in cases where the debtor has sold property in which he has granted a lien, but not accounted for the property to the lienholder. Two factual aspects of this case make the analysis a knottier problem than that which is ordinarily presented.

First, the security agreement assigned to Gilsdorf does not *appear* to be a corporate obligation. Having been executed by Gilsdorf and Reed on behalf of "Reed Sales and Service," it and the note appear to be the obligations of a partnership or joint venture. Reed argues that only the venture's property is subject to the reach of the lien. Nevertheless, both Reed and Gilsdorf seem to agree that the loan was made for the benefit of RSS. Gilsdorf testified that the transaction was intended to be corporate and not personal. The proceeds of the loan were used to repay Gilsdorf for funds he spent acquiring the press shear and brake. Those implements became property of the corporation and recovered from the corporation by Gilsdorf according to the state court order. The Court believes that notwithstanding the form of the note, it was intended to be a corporate obligation. The Bank's, and thereafter Gilsdorf's, security interest clearly attached to the corporate property securing the note.

Second, upon the lapse of the corporation Reed apparently believed the corporate assets became his property as sole shareholder of the lapsed corporation. This, however, is incorrect because there had

been no formal dissolution of RSS.[8] In the absence of a formal dissolution of RSS, title to the corporate property securing the note remained in the corporation, even though Reed dealt with it as his own.

The previous state court judgment established that the property sold or retained by Reed is in fact subject to Gilsdorf's lien. The Court must determine whether Reed's conduct amounted to wilful and malicious damage to Gilsdorf's property interests. To do so, the Court must find that Reed intended to harm Gilsdorf or that harm was substantially certain to result from his actions. As the Tenth Circuit BAP has stated, the Supreme Court's ruling in *Kawaauhau v. Geiger*[9] is a narrow reading of "willful" and is akin to the standard of deliberate injury necessary for an intentional tort.[10] It 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. Willful injury may 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]

Reed certainly understood that he (or the corporation) had granted a lien in the brake and the shear to the Bank. He should have understood the nature and extent of that lien interest in the other equipment

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[8] *See Pottorf v. United States*, 773 F.Supp. 1491 (D. Kan. 1991) (Corporation that forfeits its articles of incorporation for failure to pay state franchise taxes continues to be a legal entity and retains legal title to its property; forfeiture of articles of incorporation for nonpayment of state franchise taxes does nothing more than forfeit the corporate right to do business). *See also* KAN. STAT. ANN. §17-7510 and § 17-6806 (1995) and § 17-7002(a)(2) (2003 Supp.)

[9] 523 U.S. 57 (1998).

[10] *Mitsubishi Motors Credit of America, Inc. v. Longley (In re Longley)*, 235 B.R. 651, 656 (10th Cir. BAP 1999).

[11] *Id.* at 657.

because he was signatory to the security agreement. Upon the Bank's assignment to Gilsdorf, Reed should have understood that Gilsdorf stood to recover that property by virtue of the assignment.

But Gilsdorf has not shown that Reed acted with intent to deliberately injure him. Reed's apparent belief, though mistaken, that he succeeded to the property of the lapsed corporation as sole shareholder negates Gilsdorf's claim that Reed intended to injure him. Reed's mistaken belief is plausible and credible given the fact that Gilsdorf and Reed had parted ways concerning RSS in May of 2003 when the settlement agreement was entered into and Reed began to operate RSS as a sole proprietorship. The Court heard no evidence that Reed's conduct was motivated by an intent to injure Gilsdorf or deprive Gilsdorf of his collateral. Indeed, Gilsdorf has not shown when Reed sold the missing collateral. It could be that this occurred after the settlement agreement in May of 2003, but before Gilsdorf paid the note and acquired his security interest from the Bank. Instead, it appears that Reed simply hung on to the equipment in an effort to remain in business. A further bar to Gilsdorf's success is his failure to establish at trial the value of the property that was sold or the amounts it brought. While the amounts are likely substantial, they are not proven, and in the absence of this evidence, the Court cannot even determine that a part of the debt should be excepted from discharge. Finally, there appears to be no bar, outside that of the automatic stay, to Gilsdorf recovering the remainder of his collateral from Reed even today. The Court concludes that Gilsdorf has failed to prove a deliberate injury on the part of Reed.

Reed's debt to Gilsdorf is dischargeable. JUDGMENT on the complaint should be entered in favor of Reed and against Gilsdorf. A Judgment on Decision shall issue this day.

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