UNITED STATES BANKRUPTCY COURT
DISTRICT OF SOUTH DAKOTA
ROOM 211
FEDERAL BUILDING AND U.S. POST OFFICE
225 SOUTH PIERRE STREET
PIERRE, SOUTH DAKOTA 57501-2463

IRVIN N. HOYT
BANKRUPTCY JUDGE

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May 18, 2005

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Subject: *First Dakota National Bank, N.A. v. James J. Scoblic (In re Scoblic)*, Adv. No. 04-4071; Chapter 7, Bankr. No. 04-40923

Dear Counsel:

The matter before the Court is the Motion for Summary Judgment filed by Plaintiff First Dakota National Bank and the response filed by Defendant-Debtor James J. Scoblic. This is a core proceeding under 28 U.S.C. § 157(b)(2). This letter decision and accompanying orders shall constitute the Court's findings and conclusions under Fed.R.Bankr.P. 7052. As set forth below, the Motion will be denied.

Summary. James J. Scoblic ("Scoblic") was the president and a shareholder of Scoblic Stationers, Inc. ("stationery store"). The stationery store obtained two business loans from First Dakota National Bank ("Bank"), one on July 14, 2003, and the other on October 2, 2003. Scoblic personally guaranteed one or both of these debts.[1] The stationery store also gave the bank

[1] The present record on these guarantees appears limited. The Court was able to locate only one older guaranty by Scoblic for $15,000.00 that was attached to the Bank's original complaint. At trial, the Bank will need to produce all guarantees by Scoblic that existed on the petition date since

a security interest in several items of collateral, most notably its inventory and accounts, and the proceeds from all collateral. Under the security agreements, the stationery store agreed to hold "in trust" for the Bank any proceeds from the disposition of collateral and to "immediately deliver any such proceeds" to the Bank. Scoblic did not remit all the collateral proceeds to the Bank and used the funds for business expenses. The loans went unpaid. The stationery store closed its doors in February 2004. The Bank obtained a default judgment against Scoblic and the stationery store for the unpaid loans on June 1, 2004.

Scoblic and his wife filed a Chapter 7 petition in bankruptcy on July 8, 2004. The Bank commenced this adversary proceeding against Scoblic seeking a determination that its claim against him was excepted from discharge under either 11 U.S.C. § 523(a)(4) or (6). Under (a)(4), it argued Scoblic was the Bank's fiduciary because the stationery store had agreed to hold the collateral proceeds in trust and Scoblic violated this trust by not paying the proceeds to the Bank. Alternatively, under (a)(4), the Bank argued Scoblic had embezzled the collateral proceeds by using them for a purpose not intended by their agreement. The Bank also alternatively argued that under § 523(a)(6), its claim was excepted from discharge because it arose from the wilful and malicious acts of Scoblic in not appropriately remitting the collateral proceeds. Scoblic answered with essentially a general denial.[2]

The Bank moved for summary judgment on January 27, 2005.[3]

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they represent Scoblic's (not the stationery store's) debt to the Bank. The Bank will also need to establish the present amount of its unpaid claim against Scoblic.

[2] One answer was filed by Scoblic's counsel, and Scoblic filed another *pro se.*

[3] The parties do not dispute the applicable law for summary judgment.

Summary judgment is appropriate when "there is no

genuine issue [of] material fact and . . . the moving party is entitled to a judgment as a matter of law." Fed.R.Bankr.P. 7056 and Fed.R.Civ.P. 56(c). An issue of material fact is *genuine* if it has a real basis in the record. *Hartnagel v. Norman*, 953 F.2d 394, 395 (8th Cir. 1992)(quotes therein). A genuine issue of fact is *material* if it might affect the outcome of the case. *Id.* (quotes therein). The matter must be viewed in the light most favorable to the party opposing the motion. *F.D.I.C. v. Bell*, 106 F.3d 258, 263 (8th Cir. 1997); *Amerinet, Inc. v. Xerox Corp.*, 972 F.2d 1483, 1490 (8th Circ. 1992)(quoting therein *Matsushita Elec. Industrial Co. v. Zenith Radio*, 475 U.S. 574, 587-88 (1986), and citations therein). Where motive and intent are at issue, disposition of the matter by summary judgment may be more difficult. *Cf. Amerinet*, 972 F.2d at 1490 (citation omitted).

The movant meets his burden if he shows the record does not contain a genuine issue of material fact and he points out that part of the record that bears out his assertion. *Handeen v. LeMaire*, 112 F.3d 1339, 1346 (8th Cir. 1997) (quoting therein *City of Mt. Pleasant v. Associated Electric Coop*, 838 F.2d 268, 273, (8th Cir. 1988). No defense to an insufficient showing is required. *Adickes v. S.H. Kress & Co.*, 398 U.S. 144, 156 (1970) (citation therein); *Handeen*, 112 F.3d at 1346.

If the movant meets his burden, however, the non movant, to defeat the motion, "must advance specific facts to create a genuine issue of material fact for trial." *Bell*, 106 F.3d at 263 (quoting *Rolscreen Co. v. Pella Products of St. Louis, Inc.*, 64 F.3d 1202, 1211 (8th Cir. 1995)). The non movant must do more than show there is some metaphysical doubt; he must show he will be able to put on admissible evidence at trial proving his allegations. *Bell*, 106 F.3d 263

It argued no facts were in dispute, and it submitted case law in support of its claims.

In his response, Scoblic stated that the stationery store had done business exclusively with the Bank for 23 years and had borrowed and repaid funds during that time. He stated, "The loan funds were used to pay wages, purchase inventory, and supplies and to pay for all other business related expenses. The loans were paid off or extended depending on [the store's] cash flow." Scoblic further stated that he had used the July 14, 2003, and October 2, 2003, loan proceeds in the same manner. He said he was never advised by the Bank that the collateral proceeds were to be placed in a trust account. Scoblic conceded the loan proceeds had been dissipated paying business expenses. He further stated that after the store closed, the Bank was given all the inventory and other business property to liquidate against its claim. Scoblic cited cases in support of his argument that he was not the Bank's fiduciary as required by § 523(a)(4) and that he did not obtain the loans with the intent of causing the Bank harm, which he argued precluded relief under § 523(a)(6). In his brief, Scoblic did not address the Bank's embezzlement argument.

Scoblic also filed an affidavit in support of his response. He reviewed his understanding of the stationery store and the Bank's business relationship and how the loan proceeds were regularly used, with the Bank's knowledge, to pay accounts, purchase inventory, pay employees, and pay other general operating expenses. He denied that he knew the collateral proceeds were to be sequestered. He also stated that he did not draw a "pay check" from the stationery store during approximately the last three months it was in business.

(citing *Kiemele v. Soo Line R.R. Co.*, 93 F.3d 472, 474 (8th Cir. 1996), and *JRT, Inc. v. TCBY System, Inc.*, 52 F.3d 734, 737 (8th Cir. 1995).

In re Donald A. Hausle, Bankr. No. 04-50015, slip op. at 2-3 (Bankr. D.S.D. June 10, 2004).

In its reply brief, the Bank noted that Scoblic had failed to address its embezzlement count under § 523(a)(4). The Bank also noted that Scoblic did not refute that he (Scoblic) operated a competing office supply business out of the same location as the stationery store. The Bank restated its arguments and case law in support of a summary judgment.

Discussion - fraud by a fiduciary. The applicable law may be found in *Estate of Robert Lacey v. Jeffry L. Knopf (In re Knopf*), Bankr. No. 01-40574, Adv. No. 01-4030, slip op. (Bankr. D.S.D. March 10, 2002). For Scoblic to be the Bank's fiduciary,

> the agreement between the parties must include an explicit declaration of a trust, identify a trust *res*, and set forth the terms of a trust relationship; a mere contractual relationship is insufficient. *Werner v. Hofmann (In re Hofmann)*, 144 B.R. 459, 463-64 (Bankr. D.N.D. 1992), *aff'd,* 5 F.3d 1170 (8th Cir. 1993). The fiduciary relationship to which § 523(a)(4) applies does not cover trusts imposed on transactions by operation of law or as a matter of equity. *ITT Life Insurance Co. v. Haakenson (In re Haakenson)*, 159 B.R. 875, 887 (Bankr. D.N.D. 1993). A fiduciary under § 523(a)(4) is more narrowly defined than it is under the common law. [*E.W. Wylie Corp. v. Montgomery (In re Montgomery)*, 236 B.R. 914, 922 (Bankr. D.N.D. 1999).] Accordingly, a broad, general definition of a fiduciary relationship as one arising from confidence, trust, and good faith is not applicable under § 523(a)(4). [*Jafarpour v. Shahrokhi (In re Shahrokhi)*, 266 B.R. 702, 707 (B.A.P. 8th Cir. 2001)](quoting therein *Mills v. Gergely (In re Gergely*), 110 F.3d 1448, 1450 (9th Cir. 1997)).

Knopf, slip op. at 6.

Even if the Court were to conclude that the two security agreements created an express trust of the collateral proceeds, those documents did not set forth the terms of the trust relationship or expressly make Scoblic the trustee. Thus,

Scoblic was not serving as the Bank's fiduciary. Consequently, the Bank's claim may not be excepted from discharge under § 523(a)(4) for fraud or defalcation by a fiduciary.

Discussion - debt arising from wilful and malicious act. The Bank cited several cases in which the courts concluded a secured creditor's claim was nondischargeable under § 523(a)(6) where a corporate officer had converted the secured creditor's collateral. One of the Bank's citation was from this Circuit, *In re Wheeler*, 96 B.R. 201, 205 (Bankr. W.D. Mo. 1988), but that decision was entered well before the Supreme Court's pivotal decision in *Kawaauhua v. Geiger*, 523 U.S. 57, 61 (1998).

For this Circuit, the applicable law is better (and more recently) discussed in *Johnson v. Logue (In re Logue*), 294 B.R. 59 (B.A.P. 8th Cir. 2003).

> Pursuant to 11 U.S.C. § 523(a)(6), a discharge does not discharge an individual from a debt for willful and malicious injury. In this context, the term willful means deliberate or intentional. *Kawaauhau v. Geiger*, 523 U.S. 57, 61, 118 S.Ct. 974, 977, 140 L.Ed.2d 90 (1998); *Hobson Mould Works, Inc. v. Madsen (In re Madsen)*, 195 F.3d 988, 989 (8th Cir.1999); [additional cites omitted]. The injury, and not merely the act leading to the injury, must be deliberate or intentional. *Geiger*, 523 U.S. at 61- 62, 118 S.Ct. at 977. Malice requires conduct which is targeted at the creditor, at least in the sense that the conduct is certain or almost certain to cause financial harm. *Madsen*, 195 F.3d at 989; *[Fischer v. Scarborough (In re* Scarborough), 171 F.3d 639, 641 (8th Cir. 1999)]; *Waugh v. Eldridge (In re Waugh)*, 95 F.3d 706, 711 (8th Cir. 1996); *Barclays Amer./Bus. Credit, Inc. v. Long (In re Long)*, 774 F.2d 875, 881 (8th Cir.1985); [additional cite omitted].
>
> In order to except a debt from discharge under 11 U.S.C. § 523(a)(6), the plaintiff must establish by a preponderance of the evidence that the debt arises

from an injury which is both willful and malicious. *Grogan v. Garner*, 498 U.S. 279, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991); [additional cites omitted]....

Malice requires conduct more culpable than that which is in reckless disregard of the creditor's economic interests and expectancies. *Long*, 774 F.2d at 881. The debtor's knowledge that he or she is violating the creditor's legal rights is insufficient to establish malice absent some additional aggravated circumstances. Conduct which is certain or almost certain to cause financial harm to the creditor is required. While intentional harm may be difficult to establish, the likelihood of harm in an objective sense may be considered in evaluating intent. *Id*.

In the context of the breach of a security agreement, a willful breach is not enough to establish malice. *Phillips*, 882 F.2d at 305; *Long*, 774 F.2d at 882. As the Eighth Circuit Court of Appeals stated:

> Debtors who willfully break security agreements are testing the outer bounds of their right to a fresh start, but unless they act with malice by intending or fully expecting to harm the economic interests of the creditor, such a breach of contract does not, in and of itself, preclude a discharge.

Long, 774 F.2d at 882. A debtor's retention of proceeds of sales of collateral, while clearly a breach of a security agreement, is not enough to establish malice. Where a debtor has used the proceeds in an attempt, albeit unsuccessful one, to keep a business afloat, malice may not necessarily be inferred from the debtor's conduct. *Phillips*, 882 F.2d at 305; *Long*, 774 F.2d at 882.

....

The use of some proceeds of another's collateral to directly benefit oneself while also benefitting the

> business as a whole is not necessarily enough to render the actions malicious. *Phillips*, 882 F.2d at 305; *Lon*g, 774 F.2d at 882. Furthermore, a debtor's inability to account for every penny of the proceeds does not necessarily equate to malice. ...

Logue, 294 B.R. at 62-63; *see Gadtke v. Bren (In re Bren)*, 284 B.R. 681, 696-68 (Bankr. D. Minn. 2002)(statute cannot create express trust); and *First American Title Insurance Co. v. Lett (In re Lett)*, 238 B.R. 167, 188-90 (Bankr. W.D. Mo. 1999); *compare United States v. Foust (In re Foust*), 52 F.3d 766, 769 (8th Cir. 1995)(government's claim was nondischargeable under § 523(a)(6) where debtor, who was a director of a farm corporation, sold substantial secured grain owned by the corporate farm at locations far from the farm, he deposited the proceeds into a personal account, and he then participated in false reports that the grain had been stolen from the corporate farm silo all while payments were due by the corporate farm to the government).

When considered in the light most favorable to Scoblic, *F.D.I.C. v. Bell*, 106 F.3d 258, 263 (8th Cir. 1997), the present record does not establish that Scoblic knowingly (through "headstrong" conduct) converted the Bank's collateral or that Scoblic knew this conversion would certainly or almost certainly cause financial harm to the Bank. *Foust*, 52 F.3d at 768-69. Thus, summary judgment is not appropriate. The Bank will have to establish these two elements at trial by a preponderance of the evidence.

Discussion - embezzlement. Embezzlement is the fraudulent taking of another person's property by a debtor to whom that property was entrusted. *First National Bank v. Phillips (In re Phillips)*, 882 F.2d 302, 304 (8th Cir. 1989). For a claim to be declared nondischargeable for embezzlement under § 523(a)(4), the creditor must establish that the debtor improperly used its property before complying with some obligation to the creditor. *Werner v. Hofmann*, 5 F.3d 1170, 1172 (8th Cir. 1993)(cite therein). Implicit in an embezzlement claim under this Code section is a showing that the debtor acted with malevolent

intent. *Neff v. Knodle (In re Knodle)*, 187 B.R. 660, 664 (Bankr. D.N.D. 1995).

Scoblic failed to address embezzlement in his responsive brief. However, since one element is intent and since intent is not clear from this record, a summary determination of embezzlement is not appropriate. *United States v. One 1989 Jeep Wagoneer*, 976 F.2d 1172, 1176 (8th Cir. 1992)(where intent is at issue, summary judgment must be granted with caution).

An order will be entered denying the Bank's summary judgment motion. By separate order, the Court will schedule a final pre-trial conference during which a trial date will be set. At the trial, the Court will receive evidence on whether Scoblic's actions that resulted in the Bank's claim were wilful and malicious under § 523(a)(6) and whether Scoblic embezzled the proceeds of the Bank's collateral so as to render the debt nondischargeable under § 523(a)(4).

Sincerely,

/s/ Irvin N. Hoyt

Irvin N. Hoyt
Bankruptcy Judge

INH:sh

CC: adversary file (docket original; serve parties in interest)