UNITED STATES BANKRUPTCY COURT

DISTRICT OF ARIZONA

In Re TIMOTHY P. GUNNING and AILEEN GUNNING, Debtors.	Chapter 7 No. B-99-14866-PHX-GBN
JOHN NOEL, Plaintiff, vs. TIMOTHY P. GUNNING and AILEEN GUNNING, Defendants.	Adversary No. 00-154-GBN FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

Trial of the complaint of plaintiff John Noel, seeking to determine the dischargeability of his claim against defendants Timothy P. and Aileen Gunning was conducted on February 1 and February 7, 2001.

This court has considered the pleadings, testimony of witnesses, admitted exhibits and facts and circumstances of this case. The following findings and conclusions are entered.

FINDINGS OF FACT

1. Debtors purchased the troubled Arizona sports car manufacturer known as Hi-Tech Motorsports, Inc. in November 1992,

for $25,000, without knowledge of what value, if any, it held. Direct test., Timothy P. Gunning, Feb. 1, 2001. The company was failing at the time. Debtor now believes he should have instead shut the business down and started a new company, since he became personally liable for the previous owner's 14-15 uncompleted Cobra reproduction sports cars. Id. The company's 1998 federal tax return reported a loss of $710,742 on sales of $379,731. Ex. 33. See also Ex. 34 (1998 Arizona state tax return listing loss at $710,762). The previous year's return reports ordinary income of $277,792 on sale of $1,435,399. Ex. 35. A balance sheet of December 31, 1997 lists negative shareholder equity of $354,074.43. Ex. 37.

2. A running account, kept by debtor Aileen Gunning, indicates that by 1999 there was no profit to be made from completion of plaintiff's vehicle, a 1965-1967 reproduction Cobra sports car, powered by a Chevrolet engine. Ex. 42; Gunning direct test. It would cost Hi-Tech $6200 to complete the vehicle. Id. The April 1999 running account estimates it would cost $378,450 to complete the current vehicles in production, in order to realize an expected profit of $354,683. Ex. 42, at 2. Aileen Gunning, author of the document, was not called as a witness to explain her calculations.

3. From 1992 until the company closed in early December 1999, more than 100 Cobra reproductions were manufactured. Gunning cross-exam, Feb. 7, 2001. During this period, debtors loaned $935,440 to the entity and made draws from 1994 through 1999 of $208,557. Gunning cross-exam, Feb. 7, 2001.

4. The company ceased operations in December 1999, when creditor Zuccarelli conducted self-help repossession, breaking into the business premises and removing two trailers of inventory and equipment. The repossession included plaintiff's uncompleted vehicle. Id. Gunning testified that with certain exceptions, the company paid its debts as they came due. Cross and recross exam.

5. Plaintiff contracted with Hi-Tech in December 1994, to construct a fiberglass body Cobra automobile reproduction with a modified chassis to accept a special engine and transmission. Noel paid $16,772.50 on December 17, 1994, and made additional payments of $6,281.00 in May 1995 and $13,000.00 in July 1995. Adversary compl. ¶ 4, at 2.

6. Plaintiff, a California resident, made repeated trips to Phoenix to view the construction progress of his vehicle. Noel direct test. He also made numerous telephone calls to the company, speaking with both the general manager Michael Kenney and president Timothy P. Gunning. Id.

7. By June 1998, plaintiff concluded that progress on the vehicle was not satisfactory and he had not been treated honestly. Id. During 1997 visits to the Arizona facility, he observed that three separate fiberglass bodies would not correctly fit the custom chassis. A fourth fiberglass body installation was viewed by plaintiff in April, 1998, and was acceptable. See also Exs. 13-19. During a June 1998 visit, plaintiff was informed that this acceptable body had subsequently cracked and was being repaired off site. Plaintiff believed

that, in reality, this body had been given to another customer. Mike Kenney verified that this had occurred during a second June, 1998 visit. Noel direct test.; exs. 24-29. Kenney asked for "another chance" to complete the vehicle by a date certain. Plaintiff agreed. However, when another fiberglass body was subsequently installed, it cracked. The vehicle was never finished or delivered to plaintiff. Noel direct test., cross and redirect test., Feb. 1, 2001.

8. On February 2, 1999, plaintiff called defendant Gunning and demanded return of his money. When this did not occur, plaintiff filed suit in Maricopa County Superior Court, recovering a default judgment against Hi-Tech Motorsports, Inc. on May 24, 2000, for $71,953.08. Exs. 2, 3.

9. Earlier, in June, 1998, plaintiff and Kenney reached an agreement: If plaintiff did not inform defendant Timothy P. Gunning of Kenney's lies to plaintiff, Kenney would ensure plaintiff would be paid $200 per week until completion of his vehicle, or $45,000 if the vehicle was not finished. The vehicle's contract price was $38,000, however. Noel cross-exam. Lies by Kenney included informing plaintiff his vehicle was done, when it was not. To appease plaintiff, Kenney provided a writing dated August 18, 1998. Ex. 6. The writing promised plaintiff that Kenney would be "a friendly witness for him in any Court action." Id. In a subsequent document dated September 2, 1998, marked "Private and Confidential," Kenney provided a "guarantee, that if it becomes necessary for John Noel to bring legal action against Hi-Tech Motorsports that [I] will in no way hinder his

case. Further, I will help in any way to insure that he gets a speedy recovery of his investment up to and including being a friendly witness for his side." Ex. A. Kenney asked plaintiff not to inform debtor Gunning of this agreement. Plaintiff agreed. Noel cross-exam.

10. Neither Hi-Tech nor debtors ever conveyed title to a particular vehicle to plaintiff nor gave him keys to a vehicle. Plaintiff did not pay fees for storage of or insurance on a specific vehicle. Id.

11. Plaintiff has no personal knowledge whether Hi-Tech paid its vendors or who they were. He has met certain individuals who claim to be creditors, however. Id.

12. Michael Kenney testified he stated things to plaintiff and other customers of Hi-Tech which were not true. After plaintiff finally approved a specific fiberglass body, it was placed on the chassis of another customer, so Kenney could collect money from that person. Kenney talked with debtor Aileen Gunning concerning plaintiff's body and the company's need to pay $15,000 to $20,000 owed to the Internal Revenue Service. She and Kenney, according to Kenney, agreed to place the body approved by plaintiff on the chassis of another customer to raise money. When plaintiff appeared, Kenney initially lied about what had occurred. He subsequently confessed. It was Kenney's decision to lie to plaintiff. Direct test. and cross-exam. of Michael Kenney.

13. Michael Kenney's testimony is problematic. His testimony was evasive and nonresponsive. This difficulty,

coupled with his questionable written "guaranties to be a `friendly'" plaintiff's witness and admitted lies to customers induces this fact finder to conclude he is not a credible witness.

14. Plaintiff timely instituted this litigation on March 9, 2000, seeking a determination that his claim was nondischargeable under 11 U.S.C. section 523(a). The parties' joint pretrial statement of January 19, 2001 identified plaintiff's cause of action as arising under 11 U.S.C. section 523(a)(4) and (6).

15. To the extent any of the following conclusions of law should be considered findings of fact, they are hereby incorporated by reference.

CONCLUSIONS OF LAW

16. To the extent any of the above findings of fact should be considered conclusions of law, they are hereby incorporated by reference.

17. Pursuant to 28 U.S.C. section 1334(a), jurisdiction of this bankruptcy case is vested in the United States District Court for the District of Arizona. That court has referred, under 28 U.S.C. section 157(a), all cases under Title 11 and all adversary proceedings arising under Title 11 or related to a bankruptcy case to this court. (Amended General Order, May 20, 1985). This case and adversary proceeding having been appropriately referred, this court has jurisdiction to enter a final order and judgment determining dischargeability of particular debts. 28 U.S.C. § 157(b)(2)(I).

18. The standard of proof required of a plaintiff for dischargeability litigation is the preponderance of the evidence. This standard applies to all dischargeability proceedings, without exception. Branam v. Crowder (In re Branam), 226 B.R. 45, 52 (B.A.P. 9th Cir. 1998), aff'd, 205 F.3d 1350 (9th Cir. 1999), citing Grogan v. Garner, 111 S. Ct. 654 (1991).

19. Plaintiff objects to discharge of his claim under, *inter alia*, *section* 523(a)(4). This *section* provides that a debtor may not be discharged from a debt for fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny. 11 U.S.C. § 523(a)(4). Whether a person is a fiduciary under section 523(a)(4) is a question of federal law. Lewis v. Scott (In re Lewis), 97 F.3d 1182, 1185 (9th Cir. 1996).

20. Courts construe fiduciary in the bankruptcy discharge context as including express trusts, but excluding trusts ex maleficio, i.e., trusts arising by operation of law through a wrongful act. Blyler v. Hemmeter (In re Hemmeter), 242 F.3d 1186, 1189 (9th Cir. 2001). The Ninth Circuit refuses to deny discharge to those whose fiduciary duties were established by constructive, resulting and implied trusts. Runnion v. Pedrazzini (In re Pedrazzini), 644 F.2d 756, 758 (9th Cir. 1981); Schlecht v. Thornton (In re Thornton), 544 F.2d 1005, 1007 (9th Cir. 1976). "The core requirements are that the relationship exhibit characteristics of the traditional trust relationship, and that the fiduciary duties be created before the act of wrongdoing and not as a result of the act of wrongdoing." Runnion, 644 F.2d at 758.

21. Fiduciary relationships imposed by statute may cause the debtor to be a fiduciary under section 523(a)(4). Hemmeter, 242 F.3d at 1190 (Debtor a fiduciary under the Employee Retirement Income Security Act of 1974); Runnion at 758 n.2 (California state contractor law); Flegel v. Burt & Associates (In re Kallmeyer), 242 B.R. 492, 496 (B.A.P. 9th Cir. 1999) (Oregon trust fund doctrine).

22. Arizona recognizes the corporate trust fund doctrine. A. R. Teeters & Associates, Inc. v. Eastman Kodak Company, 836 P.2d 1034, 1041 (Ariz. App. 1992). The theory of the doctrine is that all of the assets of a corporation, immediately upon becoming insolvent, exist for the benefit of all creditors. Thereafter, no liens or rights can be created either voluntarily or by operation of law where one creditor is preferred over another. Id.

23. To prevail, plaintiff must prove that (1) corporate assets were transferred to debtors, (2) the transfer occurred while the corporation was insolvent, and (3) the transfer preferred debtors to the disadvantage of other creditors of the same priority. Liability, if established, is limited to the value of the assets received by debtors.[1] Id. A preference is a transfer or encumbrance of corporate assets made while the corporation is insolvent, which enables a creditor to receive a greater percentage of his debt than other creditors of the same

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1 A point overlooked by plaintiff, who argues that the entire amount of his judgment against the corporation is nondischargeable. Plaintiff's post-trial memo. at 7-8.

class or priority. In the absence of a prior perfected security interest or priority claim, a corporate officer is entitled only to share proportionately in the distribution of assets with other general unsecured creditors. 836 P.2d at 1043.

24. Debtors concede that the first element, a transfer of corporate assets to them in repayment of prior loans, has been established. Debtors' reply, March 22, 2001, at 2.

25. Unlike the plaintiff in A. R. Teeters & Associates, Inc., 836 P.2d at 1042, the plaintiff in this case did not produce expert evidence on whether debtors' corporation, Hi-Tech Motorsports, Inc., was insolvent at a particular date. Teeters defined insolvency using the state statutory standard of A.R.S. section 10-002(12), the "inability of a corporation to pay its debts as they become due in the usual course of its business." Id. Here, plaintiff has no knowledge of Hi-Tech's financial condition. Finding of fact no. 11.

26. Plaintiff's evidence of insolvency consisted of a reported tax loss of $710,742 for 1998, a 1997 balance sheet indicating negative shareholder equity (although a 1997 tax return reflects income of $277,792), a running account prepared by debtor Aileen Gunning, who was not called as a witness, and narrative testimony of problematic witness Kenney concerning cash flow problems at the troubled company.

27. Given this sketchy evidence, this court is unable to reconstruct a balance sheet for a particular time period to determine whether liabilities exceeded assets. Cf. Kallmeyer, 242 B.R. at 496. Nor does the narrative testimony regarding

certain unpaid debt provide a clear financial picture of this troubled company at a specific time. Accordingly, plaintiff failed to prove the insolvency predicate necessary to establish a section 523(a)(4) fiduciary relationship by a preponderance of the evidence.

28. Even if plaintiff had established the fiduciary relationship, this would not end the inquiry. Plaintiff must also prove a violation of a fiduciary duty amounting to a defalcation under section 523(a)(4). The definition of defalcation includes both misappropriation of trust property and the failure to properly account for it. No mens rea is required. However, the defalcation concept does not embrace normal acts, however flawed, which did not involve a failure to account for trust property. Hemmeter supra at 1191 (concluding that damages resulting from investment decisions of a pension plan fiduciary do not amount to a defalcation within the meaning of section 523(a)(4)).

29. It is undisputed plaintiff's long delayed body and chassis disappeared through the self-help repossession of a third party creditor. Test. of Gunning and Kenney. Plaintiff did not establish a failure to account for trust assets by debtors, nor misappropriation, larceny or embezzlement by them.

30. Section 523(a)(6) provides that a Chapter 7 bankruptcy discharge does not discharge an individual from a debt for willful and malicious injury by debtors to another entity or to that entity's property. 11 U.S.C. § 523(a)(6). The United States Supreme Court has ruled that the word "willful" in the

statute modifies the word "injury," indicating that nondischargeability requires a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury. Kawaauhau v. Geiger, 118 S. Ct. 974, 977 (1998). Thus, debts arising from recklessly or negligently inflicted injuries do not fall within section 523(a)(6). This statute triggers the category of intentional torts as distinguished from negligent or reckless torts. Intentional torts generally require that the actor intend the consequences of an act, not simply the act itself. 118 S. Ct. at 977. Accordingly, the Supreme Court has held that a medical malpractice judgment of $355,000, for a physician's substandard medical care which resulted in the amputation of plaintiff's right leg below the knee, was dischargeable. Id. at 976-78.

31. Post-Geiger, the Ninth Circuit was required to apply section 523(a)(6) to circumstances where a debtor employer chose not to pay commissions as required under an employment agreement, when he had the clear ability to make the payments. Petralia v. Jercich (In re Jercich), 238 F.3d 1202, 1204 (9th Cir. 2001). Instead of paying his employees, debtor willfully used the money for personal investments, including a horse ranch. Id. The court held Geiger had clarified that it is insufficient under section 523(a)(6) to show debtor acted willfully and that the injury was negligently or recklessly inflicted. It must be shown not only that the debtor acted willfully and maliciously, but also that the debtor inflicted the injury wilfully and maliciously, rather than recklessly or negligently. 238 F.3d at

1207. The court concluded that under Geiger, the willful injury requirement is met when it is shown either that debtor had a subjective motive to inflict the injury or debtor believed injury was substantially certain to occur as a result of his conduct. Id. at 1208.

32. The court concludes plaintiff failed to establish, by a preponderance of the evidence, either that debtors had a subjective motive to inflict injury on him or that they believed injury was substantially certain to occur as a result of allegedly[2] attaching a fiberglass body accepted by plaintiff onto the chassis of another customer. It is clear plaintiff never held legal title to, nor a security interest in, a particular fiberglass body. The body was merely a component for a vehicle being built under a contract never completed. Plaintiff had no legal right to immediate possession of the unmounted body or ownership of it. His injury is the failure to deliver the assembled vehicle, not a particular component. No conversion has occurred here, at least by the debtors. The court concludes plaintiff failed to establish the elements of section 523(a)(6) by a preponderance of the evidence.

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2 The term "allegedly" must be used given the lack of credibility of witness Kenney and plaintiff's failure to call debtor Aileen Gunning as a witness. This fact finder has not been persuaded by plaintiff's evidence as to precisely what the debtors' role was in the apparent decision to switch automotive bodies.

ORDER

IT IS ORDERED finding for defendants and against plaintiff. Plaintiff's complaint and cause of action are dismissed, with prejudice. Defendants will promptly lodge and serve a proposed final judgment. Plaintiff will be given five days from the date of service of the proposed judgment to object to the form of the judgment.

DATED this 20th day of June, 2001.

George B. Nielsen, Jr.
Chief U.S. Bankruptcy Judge

Copy mailed the 22nd day of June, 2001, to:

Mark S. Sifferman
Norling Kolsrud Sifferman & Davis PLC
3101 N. Central #690
Phoenix, AZ 85012
Attorneys for Plaintiff

Philip G. Mitchell
Jennings Haug & Cunningham LLP
2800 N. Central #1800
Phoenix, AZ 85004-1049
Attorneys for Defendants/Debtors

By _____
Deputy Clerk