UNITED STATES BANKRUPTCY COURT

THE DISTRICT OF ARIZONA

In re **HEIDI MARIE HILLE,** **Debtor.**	**Case No. 2:08-bk-4220-CGC** **Chapter 7 Proceeding**
JONATHAN HILLE, **Plaintiff,** **vs.** **HEIDE MARIE HILLE,** **Defendant.**	**Adversary 2:08-ap-485** **UNDER ADVISEMENT DECISION RE: DISCHARGEABILITY OF DEBT**

I. Introduction

During their 13-year marriage, Jonathan and Heidi Hille spent over $20,000 on musical instruments. But today they are no longer making beautiful music together. Their joint music business and their marriage ended on a sour note, with disputes about the ownership of a violin and two bows.

Mr. Hille filed this adversary proceeding against the Debtor, Ms. Hille, claiming that the instruments were property of either the couple's sole proprietorship or their jointly-owned limited liability company. He claims that Ms. Hille's sale of the instruments and her use of the proceeds give rise to debts excepted from discharge under § 523(a)(4) and (6).

To resolve these claims, the Court must address two issues: First, who owned the instruments? If the instruments were owned by either the sole proprietorship or by the limited liability company, does the sale of the property and retention of the proceeds support Mr. Hille's (a)(6) claim for willful and malicious injury? Second, does Ms. Hille, as a managing member of an LLC, have a fiduciary duty to Mr. Hille? If, yes, then did she engage in fraud or defalcation

by selling the instruments and retaining the proceeds to the detriment of Mr. Hille, thereby supporting an (a)(4) claim?[1]?

II. Facts[2]

Around 1995, Jonathan Hille formed Avant-Garde and Design Development Group ("Avant-Garde"), which he operated as a sole proprietorship for his landscape construction business. He married Ms. Hille, a violinist, in 1999. As Ms. Hille began to have income from performing and giving lessons, Avant-Garde expanded into the music business. The couple began acquiring expensive musical equipment for Ms. Hille's use about the time she was completing her undergraduate work in music. In 2003, they purchased a violin for $13,000, which appraised at $15,000. They also purchased the Knopf bow, which appraised at $3,100. Ms. Hille, who paid scant attention to financial matters, said the instruments were gifts to her from Mr. Hille for celebratory occasions such as birthdays and graduation. The instruments, however, were paid for by Avant-Garde and were listed as assets of Avant-Garde on the couple's 2003 tax returns.

Eventually, Mr. Hille separated his landscape business from the music business. From late 2004, Avant-Garde dealt solely with the music business with Mr. Hille continuing to handle its finances. In May 2005, the pair formed Avant Garde Studios ("AGS"), which replaced Avant-Garde. As an LLC, AGS is governed by its operating agreement ("Operating Agreement,") which was signed by both Mr. Hille and Ms. Hille. The Operating Agreement charged both Mr. Hille and Ms. Hille with managing the company and stated that a sale of all or substantially all of assets had to be approved by the majority. AGS's only other asset was a Ford Navigator, which Ms. Hille is surrendering as part of the bankruptcy proceedings. The Operating Agreement made no reference to fiduciary duties among members.

In April 2007, the Hilles bought the Ouchard Bow for $4,000 using personal checks. This bow appraised at $6,000. Mr. Hille claimed he did not pay with AGS funds because the seller would not accept credit cards. Ms. Hille said this bow was her combination

[1] The LLC is not a plaintiff in this case. Mr. Hille purchased Ms. Hille's interest in the LLC from the bankruptcy estate in May, 2009 and is therefore the sole owner of the entity.

[2] This decision constitutes the Court's Findings of Fact and Conclusions of Law as required by Fed. R. Bank. Proc. 7052.

graduation/birthday/anniversary gift. The Hilles' C.P.A., John E. Stevens, testified at trial that he listed the violin and Knopf bow as assets of AGS on the 2006 tax returns. He added the Ouchard bow on the 2007 tax returns. In response, Ms. Hille testified she never signed the 2006 or 2007 tax returns.

In November 2007, Mr. Hille and Ms. Hille divorced, and she formed a new LLC for her music business. Facing financial difficulties, Ms. Hille sold the violin and two bows to her former music professor in March 2008 for $20,000. She used these proceeds to pay her divorce attorney. Under the terms of the sales agreement, Ms. Hille retains the use of the three instruments and has first right of purchase for the next five years. On April 16, 2008, she filed for Chapter 7 bankruptcy. Through this adversary proceeding, Mr. Hille is seeking $25,000 for the value of the instruments plus attorney's fees and costs.

A trial was held November 16, 2009. The Court received post-trial memorandums on January 5, 2010 and responsive briefs on January 26, 2010. On January 27, 2010, Mr. Hille notified the Court of the completion of briefing, since which time the matter has been under advisement.

III. Positions of the Parties:

Mr. Hille contends that the instruments were the property of AGS. Avant-Garde paid for both the violin and the Knopf bow. Both were listed as assets of Avant-Garde on the tax returns, and both were later transferred to AGS. AGS paid for the insurance on the instruments.

Furthermore, Mr. Hille contends that Ms. Hille had a fiduciary duty to him. He argues that because Arizona Law imposes a fiduciary duty on closely-held companies such as partnerships, similar fiduciary duties within LLCs should also qualify.

Alternatively, he claims that Ms. Hille had a fiduciary duty to him under Trust Fund Doctrine. Under Trust Fund Doctrine, all of the assets of an insolvent corporation exist for the benefit of all of its creditors. *In re Weinberg*. 410 B.R. 19, 29 (B.A.P. 9th Cir. 2009). No one creditor is given an advantage over others. *Id.* (internal cites omitted.) Trust Fund Doctrine establishes a fiduciary duty for the purpose of § 523(a)(4). *Id.* at 28. Mr. Hille claims that Ms. Hille breached her fiduciary duty to him as a creditor of AGS by selling the instruments and

keeping the money. Because she deliberately deprived him of assets and used sales proceeds to retain an attorney in a divorce action against him, Mr. Hille characterizes Ms. Hille's actions as willful and malicious. Additionally, he claims this was "tortious conduct," because conversion is a tort.

On the other hand, Ms. Hill contends that the instruments were gifts to her in honor of special occasions such as anniversaries and graduations. For example, she says she received a certificate for Ouchard bow at an anniversary dinner. This bow was purchased with a personal check. Ms. Hille claims there is no record of transfer or reimbursement from AGS and no records transferring the violin or the Knopf bow from Avant-Garde to AGS.

Furthermore, Ms. Hille argues she had no fiduciary duty to Mr. Hille. Fiduciary duties among LLC members in Arizona have never been established. The Operating Agreement also failed to establish a fiduciary duty. She argues that Trust Fund Doctrine does not establish a fiduciary duty as AGS is an LLC, and Trust Fund Doctrine applies only to creditors of insolvent corporations.

Finally, Ms. Hille believes the sale of the instruments was not willful and malicious, "tortious conduct," because the instruments, in fact, belonged to her, and she had every right to sell them.

IV. Analysis

A. Ownership of Instruments

The evidence presented supports Mr. Hille's claim that the instruments were AGS's property. Arizona State law defines a transfer of assets broadly. A transfer is "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset . . . ." A.R.S. § 44–1001(9). Avant-Garde originally purchased the violin and the Knopf Bow, and all three instruments were claimed as property of AGS on income tax records. The data entry records claiming the property for tax purposes is a transfer under Arizona's broad definition. Therefore, AGS owned the instruments.

B. Section 523(a)(4)

Under § 523(a)(4) a debt is non-dischargeable if there is "fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny." 11 U.S.C. § 523(a)(4). Arizona common law has established nine elements for claims of fraud:

> (1) a representation, (2) its falsity, (3) its materiality, (4) the speaker's knowledge of its falsity or ignorance of its truth, (5) the speaker's intent that the information should be acted upon by the hearer and in a manner reasonably contemplated, (6) the hearer's ignorance of the information's falsity, (7) the hearer's reliance on its truth, (8) the hearer's right to rely thereon, and (9) the hearer's consequent and proximate injury.

Taeger v. Catholic Family and Comty. Serv., 995 P.2d 721, 730 (Ariz. Ct. App. 1999) (citation omitted). Fraud is not presumed. *Rhoads v. Harvey Publ'n*, 700 P.2d 840, 844 (Ariz. Ct. App.1984). "The proof of fraud must be sufficient to overcome the initial presumption of honesty." *Id.* The burden of proof, therefore, is on Mr. Hille to show that Ms. Hille's sale of the instruments was fraudulent. To meet this burden, there must be a "hearer" who both relied on the truth of the representations and suffered proximate injury. *Taeger*, 995 P.2d 721, 730. While Mr. Hille may have suffered proximate injury from the sale of the instruments, he did not demonstrate that he relied on the truth of Ms. Hille's representations. Nor was there evidence of any other "hearer's consequent and proximate injury." As these are necessary elements, fraud is not proven.

Mr. Hille's defalcation claim, though, is not so easily dismissed. Defalcation is the failure of a party to account for money or property that had been entrusted to her. In the context of § 523(a)(4), this includes innocent, as well as intentional or negligent defaults. *In re Baird,* 114 B.R. 198, 204 (BAP 9th Cir. 1990) (citation omitted)). In this case, the instruments, which were the property of AGS, were entrusted to Ms. Hille. However innocent her intentions, she committed defalcation when she sold them and used the funds to pay her divorce attorney.

However, Section 523 (a)(4) makes it clear that to prevent a discharge, the defalcation must occur while the debtor is acting in a fiduciary capacity. Therefore, the Court must first determine if Ms. Hille had a fiduciary duty to Mr. Hille. Under § 523(a)(4), a fiduciary capacity applies only in specific contexts. *Id.* It must arise from a breach of trust obligations imposed by law, separate and distinct from a contract. *Id.* While the existence of a fiduciary relationship

under § 523(a)(4) is determined by federal law, courts should consult state law to determine if trust obligations exist. *Ragsdale v. Haller*, 780 F.2d 794, 796 (9th Cir. 1986).

Arizona statues are silent on whether there is a fiduciary duty among LLC members. An Arizona Appeals Court decision footnote quoted Rev. ULLCA § 409(g)(5) (2006) stating that, in a manager-managed limited liability company, "[a] member does not have any fiduciary duty to the company or to any other member solely by reason of being a member." *Sports Imaging of Ariz. v.1993 CKC Trust*, No. 1 CA-CV 05-0205, 2008 WL 4448063, at *19 (Ariz. Ct. App. Sept. 30, 2008) (not reported). But this same court also noted ULLCA is non-binding. *Id.* So far, Arizona has not established either a statutory or common law fiduciary duty among LLC members.

However, fiduciary duties among LLC members may be expressly created in operating agreements. Under Arizona Law, an operating agreement governs the relationships between the members and managers of limited liability companies. A.R.S. § 29-682. While the Operating Agreement could have established fiduciary duties among its member, in this case, it does not.

Although Arizona is silent on fiduciary duties among LLC members, it does impose a fiduciary duty upon partners in a partnership for the context of § 523(a)(4). *In re Lewis*, 97 F.3d 1182, 1186 (9th Circ. 1996). A fiduciary duty under § 523(a)(4) has also been established for corporations through Trust Fund Doctrine. *In re Weinberg*. 410 B.R. 19, 28 (BAP 9th Cir. 2009). However, this case is about the fiduciary duty among members of an LLC, not about partners in partnership or creditors of an insolvent corporation. The State has previously expressly established fiduciary duty for partnerships and corporations. It could have established fiduciary duties among LLC members if that were its intention. Because Arizona has not established a fiduciary duty among LLC members, Mr. Hille has not met his burden of proof.

The last claim under § 523 (a)(4) in this case is embezzlement, which unlike defalcation, does not require a fiduciary duty. Instead, the elements of embezzlement under § 523(a)(4) are: "(1) property rightfully in possession of a nonowner; (2) nonowner's appropriation of the property to a use other than that [for] which it was entrusted; and (3) circumstances indicating fraud." *In re Littleton,* 942 F.2d 551, 555 (9th Cir. 1991) (internal cites omitted.) For reasons

previously discussed, fraud is not established in this case. Because an indication of fraud is a necessary element, the embezzlement claim fails. As there was no fiduciary duty or embezzlement, § 523(a)(4) does not apply.

C. Section 523(a)(6)

Under § 523(a)(6) a debt is non-dischargeable "for willful and malicious injury by the debtor. . . ." 11 U.S.C. § 523(a)(6). For § 523(a)(6) to apply, there must also be "tortious" conduct. *Lockerby v. Sierra*, 535 F.3d 1038, 1044 (9th Cir. 2008). In other words, there must be conduct which would give rise to a tort such as conversion under state law. Conversion is defined as "an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel." RESTATEMENT (SECOND) OF TORTS § 222A(1) (1965) adopted by Arizona. Ms. Hille's sale of the instruments and retention of the proceeds seriously interfered with Mr. Hille's right to control this property. Therefore, her actions qualify as tortious conduct under Arizona law.

Along with tortious conduct, the court must also establish willful and malicious conduct. In the past, a wrongful act such as conversion, done intentionally, was considered "willful and malicious" and did not require intent to injure. *In re Cecchini*, 780 F.2d 1440, 1443 (9th Cir. 1986). That changed in 1998 with *Kawaauhau v. Geiger.* 523 U.S. 57 (1998). In *Geiger*, Supreme Court determined that "willful" under subsection (6)(a) required a "deliberate or intentional injury, not merely a deliberate or intentional act which causes injury." *Id.* at 61. Post-*Geiger*, the Ninth Circuit has determined the "willful" injury requirement of § 523(a)(6) is met when "it is shown either that the debtor had a subjective motive to inflict the injury *or* that the debtor believed that injury was substantially certain to occur as a result of his conduct." *In re Jercich*, 238 F.3d 1202, 1208 (9th Cir. 2001) *cert. denied,* 533 U.S. 930. It defined "malicious" as a wrongful act, done intentionally, which necessarily causes injury, and which is done without just cause or excuse. *Id*. at 1209.

In *In re Peklar,* a debtor mistakenly believed that she had a legal right to remove and store furniture from her leased premises. *In re Peklar,* 260 F.3d 1035 (9th Cir. 2001). Using

Geiger as a standard, the court found her conversion did not rise to the level of "willful and malicious injury" for debt discharge purposes. *Id.* at 1039. Much like the debtor in *Peklar* who believed she could remove her furniture, Ms. Hille believed she had a legal right to sell the instruments and retain the proceeds for her personal use. As there was no malicious action, the debt is not non-dischargeable under § 523(a)(6).

D. Attorney's Fees

The Supreme Court held that creditors are not precluded from filing unsecured claim for attorney's fees incurred in litigating issues of federal bankruptcy law. *Travelers Cas. and Sur. Co. of Am. v. Pac. Gas and Elec. Co.*, 549 U.S. 443 (2007). This has also been expanded to debtors seeking to recover attorney's fees. *In re DeRoche*, 434 F.3d 1188 (2006), *vacated*, 127 S.Ct. 1873 (2007). However, attorney's fees and cost are awarded only when there is clear and convincing evidence the claim is groundless and not made in good faith. A.R.S. § 12-341.01. While it is possible to award attorney's fees in bankruptcy matters, in this case the claims are not groundless or made absent good faith. Therefore, no fees or costs are awarded.

V. Conclusion

The debt is not non-dischargeable under § 523(a)(4) or § 523(a)(6).

IT IS ORDERED that Plaintiff's Complaint is dismissed and no attorney's fees and costs shall be awarded.

DATED: March 24, 2010

CHARLES G. CASE II
UNITED STATES BANKRUPTCY COURT

COPY of the foregoing mailed by the BNC and/or sent by auto-generated mail to:

DENNIS I. WILENCHIK
WILENCHIK & BARTNESS, P.C.
2810 N. THIRD ST.
PHOENIX, AZ 85004

HAROLD 1 CAMPBELL
CAMPBELL & COOMBS, P.C.
1811 S. ALMA SCHOOL ROAD
SUITE 225
MESA, AZ 85210