UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW HAMPSHIRE

In re:

Bk. No. 00-10037-JMD
Chapter 7

Connie C. Timlake,
Debtor

Edward Brown and
Elaine Brown, Co-Trustees of the Appletree Trust,
Plaintiffs

v.

Adv. No. 00-1043-JMD

Connie Timlake,
Defendant

Mark P. Cornell, Esq.
MARK P. CORNELL ATTORNEY AT LAW
Attorney for Plaintiffs

William A. Whitten, Esq.
LAW OFFICE OF WILLIAM A. WHITTEN
Attorney for Debtor/Defendant

MEMORANDUM OPINION AND ORDER

I. INTRODUCTION

On February 22, 2001, the Court held a trial regarding a complaint filed pursuant to 11 U.S.C. § 523(a)(4) and (a)(6), and 11 U.S.C. § 727(a)(2) and (a)(4)(A). Evidence was presented by both parties and at the end of the trial the Court took the matter under submission.

This Court has jurisdiction of the subject matter and the parties pursuant to 28 U.S.C. §§ 1334 and 157(a) and the "Standing Order of Referral of Title 11 Proceedings to the United States Bankruptcy Court for the District of New Hampshire," dated January 18, 1994 (DiClerico, C.J.). This is a core proceeding in accordance with 28 U.S.C. § 157(b).

II. FACTS

In August of 1997 the Debtor, doing business as Gooseberry Bakery and Take-Out, entered into a lease agreement (the "Lease") with Edward and Elaine Brown (the "Browns"), as managers of the Appletree Trust (the "Trust"),[1] whereby the Debtor leased retail space from the Trust in which she intended to open a bakery. In October of 1997 the Debtor borrowed $25,000.00 from the Trust to open her bakery. In conjunction with borrowing $25,000.00 from the Trust the Debtor signed a Promissory Note (the "Note") and a document entitled "Security Interest."[2] Both the Note and the Security Interest contain language granting the Trust a security interest in the bakery's inventory and equipment. Prior to trial it had been agreed upon by the parties that the Security Interest had not been properly perfected under state law.[3]

The testimony at trial was that the rent payments due under the Lease were not being collected on time and that only one partial payment had been made with regards to the Note. On March 11, 1999, Elaine Brown, as manager of T-R-S: Trust, sent a letter to the Debtor reminding her of her past due payment obligations under the Lease and Note and of her obligation to not remove any property from the business premises as it would be sold by the Trust "in an attempt to recover some of its cost." See Exhibit 4.

On December 16, 1999, the Debtor had her first meeting with Attorney William Whitten ("Whitten"), who later became the Debtor's counsel with regards to her bankruptcy filing. It was sometime after this meeting that Whitten checked to see if the proper documents had been filed with regards to the Security Interest in the business inventory and equipment. On December 24, 1999, the Debtor closed her business and removed her personal items, but not business property, from the bakery premises. Based

---

[1] It appears that the Browns hold all, or substantially all, of the beneficial interests in the Trust.

[2] Although the Security Interest is not dated, the testimony at trial of the Debtor was that the document was signed around the same time as the Note, which is dated October 20, 1997.

[3] The Trust apparently filed only one copy of the Security Interest at the Grafton County registry of Deeds.

upon her discussions with Whitten, the Debtor believed that she could remove and sell the business property because the Trust had not "filed" its security interest. During the week between Christmas and New Year's Eve the Debtor sold most of the equipment and supplies such as tables, a cooler, a display case, the oven, and flour (hereinafter the "Equipment") to various third parties. In total, the Debtor testified that she received approximately $3,400.00 in proceeds from the sale of the Equipment. The Debtor used the money from the sale of the Equipment to pay several months of apartment rent ($1,700.00), telephone bills ($150.00), electric bills ($400.00), oil bills ($300.00) and to purchase food. The Debtor further testified that she used some of the money to pay filling fees and attorney's fees ($850.00) associated with her bankruptcy filing.

The Debtor understood that under the terms of the Security Interest the Trust could have taken her business property as collateral for her loan. She also testified that she knew that if she removed the business property, the Trust would lose the benefit of the Security Interest. The Debtor further testified that the Browns had been very good to her and had tried to help her succeed with her business. Notwithstanding that help, by the end of 1999 she was several months behind in her apartment rent and utility payments, had received several shutoff notices, and was in danger of being evicted.

At trial, the Debtor candidly admitted that she had not listed the proceeds from the sale of the Equipment in answer to either question one or two in her statement of financial affairs despite the fact that the Equipment had been sold prior to her signing of the statement of financial affairs. The Debtor also admitted that she had not listed the sale of Equipment in answer to question ten in her statement of financial affairs. The Debtor, however, did state that the schedules and statement of affairs were initially prepared prior to the sale of the Equipment. Finally, the Debtor admitted that she did not list her payments to her landlord in answer to question 3a in her statement of financial affairs. The Debtor stated that she did not think of her landlord as a creditor and instead viewed him as someone she owed on a month to month basis.

III. DISCUSSION

A. Section 523(a)(4)

Under 11 U.S.C. § 523(a)(4) a debtor may not be discharged from a debt for embezzlement. The Trust claims that the Debtor's sale of the Equipment in which the Trust held a valid, but unperfected, security interest, and the use of the proceeds for her personal benefit constitute embezzlement. Therefore, the Trust claims that the debt owed to it should not be discharged. In order to prevail on this count the Trust must prove each element of section 523(a)(4) by a preponderance of the evidence. See Grogan v. Garner, 498 U.S. 279, 283, 291 (1991).

The definition of embezzlement, as the term is used in the Bankruptcy Code, is to be determined by federal common law. See e.g., Nat'l City Bank v. Imbody, 104 B.R. 830, 840 (Bankr. N.D. Ohio 1989) (citations omitted). The basic definition of embezzlement "is the fraudulent appropriation of property by a person to whom such property has been entrusted, or into whose hands it has lawfully come." Moore v. United States, 160 U.S. 268, 269 (1895); see also Deere & Co. v. Contella, 166 B.R. 26, 30 (Bankr. W.D.N.Y. 1994); Maine Bonding & Cas. Co. v. Crook, 13 B.R. 794, 798 (Bankr. D. Me. 1981). In order to be successful on an embezzlement claim under section 523(a)(4) a creditor must show that the debtor acted with fraudulent intent or deceit. Crook, 13 B.R. at 798. Further, retention by a debtor who is acting in good faith and with a reasonable claim of right without secrecy or concealment is generally inconsistent with the fraudulent intent necessary for embezzlement. Id.

In the case at hand, the Debtor testified that it was only after her discussions with Attorney Whitten that she decided to remove and sell the Equipment. Prior to those discussions she was unaware of a filing requirement for security interests. Although the Debtor testified that she understood that the Security Interest gave the Trust the right to take the Equipment to recover on its loan, it was only after her discussions with Attorney Whitten that she sold the equipment and used the proceeds to pay necessary living expenses in order to "survive" and "stay warm." In her bankruptcy schedules, prepared with the assistance of Attorney Whitten, the Debtor listed the Trust as an unsecured creditor for a debt arising from an "unsecured promissory note - 1997." See Exhibit 5, Schedule F. Prior to her discussions with Attorney

Whitten the Debtor was unaware of any filing requirement for security interests. After those discussions, and before the sale of the Equipment, she understood that the Trust had not properly "filed" the Security Interest. Based upon the evidence, the Court finds that the Trust has not established that the Debtor had the fraudulent intent necessary to establish embezzlement under section 523(a)(4).

The Debtor is not legally sophisticated and did not understand the legal significance of the perfection of the Security Interest by the Trust or the legal effect of a valid, but unperfected, security interest between the parties. The Debtor did have an understanding of the legal effect of an unperfected security interest until she learned about the filing irregularities from her attorney. There is no evidence that the Debtor took any action to interfere with the Trust's rights under the Security Interest prior to learning of the filing irregularities. The evidence shows that the Debtor did not act with an intentional or reckless disregard of the Trust's rights under the Security Interest. It was only after she consulted with her attorney that she concluded that she could remove and sell the Equipment.

The evidence also supports a conclusion that the Debtor's removal and sale of the Equipment was undertaken to enable her to avoid eviction and termination of utilities in the winter, not with any intent to harm the Trust. Furthermore, no evidence was presented to show that the Debtor had made any attempt to conceal the sale of the Equipment. The Trust has failed to prove by a preponderance of the evidence that the Debtor acted with fraudulent intent when selling the Equipment. The Trust's claim under section 523(a)(4) is denied.

B. Section 523(a)(6)

A debtor's discharge may be denied for the willful and malicious injury by the debtor to another entity or the property of another entity. 11 U.S.C. § 523(a)(6). In order to constitute a willful injury the act must be deliberate or intentional. Printy v. Dean Witter Reynolds, Inc., 110 F.3d 853, 859 (1st Cir. 1997). This means that an act that is done intentionally and which will necessarily cause harm or which is substantially certain to cause harm may be considered a willful and malicious injury. Id. However, "the

word 'willful' in (a)(6) modifies the word 'injury,' indicating that nondischargeability takes a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury." Kawaauhau v. Geiger, 523 U.S. 57, 61 (1998). In order to qualify as a malicious injury the act must be wrongful and without just cause or excuse. Printy, 110 F.3d at 859. The malice required by section 523(a)(6) requires an intent to cause harm; recklessness or negligence will not suffice. Id.; see also Geiger, 523 U.S. at 64. The Trust must prove each element of section 523(a)(6) by a preponderance of the evidence. See Grogan v. Garner, 498 U.S. 279, 283, 291 (1991).

The Debtor sold the Equipment and by doing so arguably caused injury to the Trust. However, for the reasons set forth in section III.A above, the evidence does not support a finding that the Debtor acted with actual intent to harm the Trust. In addition, the Trust's failure to properly perfect its security interest would have likely resulted in the value of the Equipment being realized by the Chapter 7 trustee with the Trust only receiving a pro-rata share of any distribution to unsecured creditors, not the Equipment or the proceeds in their entirety. The Court finds that the Trust has failed to prove by a preponderance of the evidence that the Debtor acted with an intent to harm the Trust or its property. The Trust's claim under section 523(a)(6) is denied.

C. Section 727(a)(2)

A debtor's discharge will be denied if the debtor, with the intent to hinder, delay, or defraud a creditor removed, transferred, concealed, or destroyed property of the debtor within one year of the filing of the petition. 11 U.S.C. § 727(a)(2)(A). In order to be successful on this count the Trust must prove, (1) the Debtor transferred property; (2) the transfer occurred within one year of filing for bankruptcy; and (3) the Debtor transferred the property with the actual intent to hinder, delay, or defraud the Trust. The Trust must prove each of these elements by a preponderance of the evidence. See Rhode Island Depositors Econ. Prot. Corp. v. Hayes, 229 B.R. 253, 259 (B.A.P. 1st Cir. 1999) (citations omitted).

It was clear from the testimony at trial that the first two elements of section 727(a)(2)(A) were established by the Trust. The Debtor sold the Equipment in late December of 1999 and then filed for

bankruptcy on January 7, 2000. Clearly the Debtor had transferred property within one year of filing. The remaining question is whether the Debtor transferred the property with the intent to harm the Trust.

The Debtor testified that after discussions with her attorney she believed she could remove and sell the Equipment because the Trust had not properly "filed" its Security Interest. The Trust contends that when the Debtor sold the Equipment she knew the Trust had a security interest and that the Trust had the right to take the Equipment to recover on her debt. Therefore, the Trust argues, the Debtor intended to harm it by acting against its rights under the Security Interest. While the Debtor's actions may have harmed the Trust, there was no evidence that the Debtor intended to harm the Trust or the Browns when she sold the Equipment. Nor was there any evidence that the Debtor had any animosity toward the Trust or the Browns. In fact, the Debtor's own testimony was that the Browns had been very good to her and had tried to help her with her business. The evidence supports a conclusion that the Debtor removed and sold the Equipment only after she learned of the failure of the Trust to properly "file" the Security Interest from her attorney, and then only to raise money to prevent eviction or shutoff of utility services in the winter. There was no evidence that the Debtor intended to harm the Trust by selling the Equipment. The Trust's claim under section 727(a)(2)(A) is denied.

D. Section 727(a)(4)(A)

A debtor's discharge may be denied if the debtor knowingly and fraudulently made a false oath or account in connection with the case. 11 U.S.C. § 727(a)(4)(A). In order to be successful, the Trust must prove that the Debtor knowingly and fraudulently made a false oath as to a material fact in connection with the case. See, e.g., Grogan v. Garner, 498 U.S. 279, 283, 291 (1991); Desmond v. Varrasso, 37 F.3d 760, 764 (1st Cir. 1994); Boroff v. Tully, 818 F.2d 106, 110 (1st Cir. 1987); Smith v. Grondin, 232 B.R. 274, 276 (B.A.P. 1st Cir. 1999); Riggs v. Cross, 156 B.R. 884, 887 (Bankr. D.R.I. 1993). A debtor's schedules and statement of financial affairs are unsworn declarations made under the penalty of perjury and are the

equivalent of a verification under oath. See Grondin, 232 B.R. at 276. A fact is material when it bears a relationship to the debtor's business transactions or concerns the discovery of assets, business dealings, or the existence and disposition of the debtor's property. See Tully, 818 F.2d at 110-11; Grondin, 232 B.R. at 276.

A debtor's discharge should not be denied under section 727(a)(4)(A) for omissions or false statements that are due to inadvertence, mistake, or when the mistake is technical and not real. See Gordon v. Mukerjee, 98 B.R. 627, 629 (Bankr. D.N.H. 1989). "A trivial matter which has but little effect upon the estate and the creditors is treated as immaterial." Id. at 629 (quoting Field v. Irving (In re Irving), 27 B.R. 943, 945 (Bankr. E.D.N.Y. 1983) (citations omitted)). However, a debtor's reckless indifference to the truth is treated as the functional equivalent of fraud. See Grondin, 232 B.R. at 277-78 (citations omitted).

In this case, the Debtor has admitted that her statement of financial affairs contained errors of omission. The Debtor further admitted that the Equipment had been sold prior to the time she signed the schedules and statement of financial affairs. Specifically, the Debtor admits that she did not list the proceeds from the sale of the Equipment in answer to either question one or two in her statement of financial affairs. The Debtor also admitted that she had not listed the sale of Equipment in answer to question ten in her statement of financial affairs. Finally, the Debtor admitted that she did not list payments to her landlord in answer to question 3a in her statement of financial affairs.

The Trust contends that the Debtor falsely filled out her statement of financial affairs and that under section 727(a)(4)(A) her discharge should be denied. The Trust seeks a denial of the Debtor's discharge under section 727(a)(4)(A) based upon her alleged failure to disclose the transfer of the Equipment, her failure to disclose all of the business assets remaining in her possession, and her failure to list the Trust's claim as secured. See Doc. No. 1. During the trial the Trust added another claim based upon the Debtor's failure to list payments to her landlord in answer to question 3a in her statement of financial affairs. Under Federal Rule of Civil Procedure 15(b), made applicable to bankruptcy proceedings by Federal Rule of Bankruptcy Procedure 7015, when issues are not raised in the pleadings, but are tried by

express or implied consent of the parties, the issues shall be treated as though they had been raised in the pleadings. Since the Debtor did not object to the new claim during the trial, the Court will treat the claim as if it had been raised in the pleadings. During the trial, the Trust also withdrew all claims except those relating to the omissions in the answers to questions one, two, three, and ten in the statement of financial affairs.

The Court will begin by examining the Debtor's failure to list her payments to her landlord in question 3a of her statement of affairs. It is clear from the Debtor's testimony that the omission was not intentional. The Debtor's testimony revealed that the payments to her landlord were not listed because she did not consider him to be a creditor. As rent is generally paid in advance and residential lessors rarely send a "bill," debtors frequently do not view their lessor as a creditor. Bankruptcy counsel should not mistake the status of a residential lessor. However, there was no evidence that the Debtor's use of the proceeds from the sale of the Equipment was concealed from her attorney. The Court finds nothing in the evidence presented that would lead to a conclusion that the omission of the payments to the lessor was not inadvertent.

Next, there is the failure of the Debtor to list the sale and the proceeds from the sale of the Equipment in the answers to questions one, two, and ten in her statement of financial affairs. To begin with, the Court notes that question one requires the debtor to list income that the debtor has received from employment or operation of a business. The sale of the Equipment is not income from the operation of a business. The Debtor was not in the business of selling bakery equipment; therefore, the sale of the Equipment was not income from operation of the Debtor's business. The proceeds were income from liquidation of the business. Accordingly, the Debtor was not required to list the sale of the Equipment in answer to question one in her statement of financial affairs.

Question two requires the debtor to list income received within two years prior to filing bankruptcy, from sources other than employment or operation of a business. The Trust is correct in arguing that the proceeds received from the sale of the Equipment could have been listed in the answer to question two.

Technically, under state and federal tax laws, the proceeds from the sale of the Equipment would be income that the Debtor had received within the two years prior to her filing. However, the Court notes that the average lay person, and perhaps many attorneys, would not view the proceeds from such a sale as income in the context of a bankruptcy petition. The Court finds that the Debtor's failure to list the proceeds from the sale of the Equipment in the answer to question two to be a technical error and not an intentional omission.

The remaining issue to be dealt with is the Debtor's failure to list the sale of the Equipment in answer to question ten of her statement of financial affairs. Question ten requires a debtor to list all other property transferred, other than in the ordinary course of business, within one year prior to filing. The Debtor should have listed the sale of the Equipment in answer to question ten. The Equipment was sold outside of the ordinary course of her business and was sold within one year of her filing. Even if the Debtor thought that the Equipment was not subject to the Trust's Security Interest, she should have disclosed the sale of the Equipment in the answer to question ten.

The question is whether the Debtor acted knowingly and fraudulently when she omitted the information on the sale from her answer to question ten. The sale of the Equipment occurred only a few weeks prior to the bankruptcy filing, at a time when the Debtor was consulting with her attorney and obviously contemplating bankruptcy. Therefore, it would be difficult for the Debtor to claim that she forgot about the sale of the Equipment, and she does not claim that she had forgotten about the sale. However, upon examination of the Debtor's schedules it is difficult to say that the Debtor acted knowingly and fraudulently.

In her petition the Debtor listed the business in the other names section as "d/b/a Gooseberry Bakery." Further, in answer to question sixteen in her statement of financial affairs the Debtor listed the operation of her business from September of 1997 to December of 1999, the month before the filing of her petition. Finally, in item 27 of Schedule B the Debtor lists four tables and four chairs as business equipment that she still possessed. A trustee or creditor looking at the answers to these three questions would not be

deceived about the Debtor's operation of a business for several years up until the month before the filing of the petition and that only a few *de minimis* items of equipment were in the Debtor's possession on the petition date. The answers to the above three questions would naturally raise questions about the absence of secured creditors in Schedule D, possible prepetition repossession of equipment by a secured creditor or a lessor, a prepetition sale of equipment, or an omission from the schedules. Why would the Debtor knowingly and fraudulently omit information on the sale of the equipment from her answer in question ten and yet include the information mentioned above in other parts of her schedules or statement of affairs? The information that the Debtor provided in her schedules and statement of financial affairs strongly suggested that something was missing from some other part of the schedules. It would make no sense for the Debtor to knowingly fill out question ten incorrectly, as the information was bound to be revealed at a later date. Accordingly, the Court finds that the Debtor did not knowingly or fraudulently omit information on the sale of the Equipment from her answer to question ten.

However, even if the Debtor did not knowingly and fraudulently omit information from her schedules, a reckless disregard for the accuracy of bankruptcy schedules and the statement of affairs has been held to be the equivalent of fraud. See Grondin, 232 B.R. at 277-78 (citations omitted). Therefore, the Court must determine whether the Debtor's conduct rises to the level of reckless disregard for the truth. Was the Debtor's failure to included information on the sale in her answer to question ten negligent? The question must be answered affirmatively. Does her failure to do so rise to the level of recklessness? The answer to this question is not so easily answered.

The Trust cites this Court's recent decision in Marshall v. Kalantzis (In re Kalantzis), 2001 BNH 009, as support for denial of the Debtor's discharge under section 727(a)(4)(A). In Kalantzis the debtor had not only omitted information from his schedules, but had entered incorrect information in his schedules and statement of affairs. Further, the debtor's entries and omissions were so far from the truth that a trustee or creditor reviewing the schedules would be misled about the truth of the debtor's financial affairs. Finally, due to the fact that all of the omissions and incorrect entries were consistent with each other there was

nothing to indicate to a trustee or creditor that the schedules were incorrect or incomplete. Such a consistent failure in omitting information and entering incorrect information is indicative of a knowing and fraudulent action or a reckless disregard for the truth on the part of the debtor.

The Court finds that this case is distinguishable from Kalantzis. First, this is not a case where the Debtor submitted schedules that contained consistent incorrect entries and omissions. Here the Debtor made one omission, her failure to include information on the sale of Equipment in the answer to question ten. Second, any trustee or creditor reading the Debtor's schedules and statement of affairs would realize that information regarding the remaining bakery equipment appeared to be missing from the Debtor's petition and statement of affairs. One can not operate a bakery without equipment. While the equipment might have been repossessed, sold, or omitted from the schedules, something should have been disclosed in her bankruptcy papers. Third, the Debtor's omission from the schedules would not mislead a trustee or creditor. For instance, a trustee or creditor could assume that the bakery equipment had been repossessed by a secured lender. However, based upon the information in the Debtor's schedules the reader would have to be aware that it would be equally plausible that the equipment had been sold by the Debtor or omitted from the schedules. A trustee or creditor would be able to determine that additional inquiry was appropriate.

While the Debtor's actions may have been negligent, the Court can not find that they rise to the recklessness necessary to deny the Debtor's discharge. Based upon the testimony and evidence presented at trial, the Court can not find that the Debtor acted in a reckless manner. Even assuming for the sake of argument that the omission of the sale related to a material fact, a preponderance of the evidence did not show that the Debtor acted knowingly and fraudulently or with a reckless disregard for the truth. The Trust's claim under section 727(a)(4)(A) is denied.

IV. ORDER

For the reasons set forth in this opinion, the Trust has failed to meet its burden of proof with regards to its section 523(a)(4), 523(a)(6), 727(a)(2), and 727(a)(4)(A) claims and its complaint to deny the Debtor's discharge is denied. The Debtor will receive her discharge in the ordinary course.

This opinion and order constitutes the Court's findings of fact and conclusions of law in accordance with Federal Rule of Bankruptcy Procedure 7052.

DATED this 20th day of April, 2001, at Manchester, New Hampshire.

____
J. Michael Deasy
Bankruptcy Judge