UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF GEORGIA
ALBANY DIVISION

IN RE: CASE NO. 99-10321-JTL

CROMER FARMS, INC.,

DEBTOR.

CROMER FARMS, INC., ADVERSARY PROCEEDING NO. 99-1015-JTL

PLAINTIFF,

V.

TY TY PEANUT COMPANY, INC.,

DEFENDANT.

MEMORANDUM OPINION

Procedural History and Default Judgment Issue

Debtor filed this Adversary Proceeding on March 30, 1999 seeking the recovery of certain allegedly preferential payments. Defendant, Ty Ty Peanut Company, Inc. ("Ty Ty"), answered and counterclaimed for its debt to be determined nondischargeable under § 523 of the Bankruptcy Code ("Code"). Debtor did not timely answer the counterclaim. The clerk entered a default against Debtor on the counterclaim on June 10, 1999. (Doc. 8.)

Subsequently, counsel for both parties submitted and the court signed a consent order with an attached stipulation

extending the time in which Debtor could answer the counterclaim. (Docs. 10 and 9.) Debtor answered within the time allowed by the consent order. (Doc. 11.) Based upon the language of the consent order, the default judgment was therefore waived unless Ty Ty can succeed in arguing either that the Chapter 12 case would not have been dismissed upon motion of Debtor, or that even if the Chapter 12 case had been dismissed upon Debtor's motion, the court would have retained jurisdiction over this Adversary Proceeding and entered a default judgment.

Under the first argument, the court agrees with cases that hold that a debtor's right to voluntarily dismiss a Chapter 12 case is not unlimited. See Graven v. Fink (In re Graven), 936 F.2d 378 (8th Cir. 1991) (court may delay action on debtor's voluntary dismissal until fraud is investigated; if fraud is shown, court may convert case to Chapter 7 despite debtor's motion to dismiss); In re Goza, 142 B.R. 766 (Bankr. S. D. Miss. 1992) (court may delay action on debtor's voluntary dismissal until debtor provides an accounting). These cases stand for the proposition that it was not Congress's intent in enacting §1208(b) of the Code that chapter 12 become "a frequently traveled thoroughfare for the unscrupulous seeking to hinder, delay and defraud their creditors." 142 B.R. at 771. The court in Graven discussed the interaction between subsections 1208(b) and (d) of the Code:

> We conclude that the broad purpose of the bankruptcy code, including Chapter 12, is best served by interpreting section 1208(d) to allow a court to convert a case to Chapter 7 upon a showing of fraud even though the debtor has moved for dismissal under subsection (b). . . . Once fraud is found, the provisions of section 1208(d) are triggered and the court has the authority, under subsection (d), to dismiss the case or convert it to Chapter 7.

936 F.2d at 385.

Accordingly, for Ty Ty to succeed under the first argument, it would have to prove that Debtor had abused the purposes of chapter 12 by engaging in fraud. Ty Ty has failed to present the court with evidence of Debtor's attempting to defraud its creditors. Therefore, this chapter 12 case would have been dismissed upon Debtor's motion.

Under the second argument available to Ty Ty in the consent order, the counterclaim asks that Ty Ty's debt be excepted from the discharge that may be entered upon completion of a plan in this case. If the case had been dismissed upon Debtor's motion, the court would have found this Adversary Proceeding to be moot, as no discharge would be possible, and would have refused to retain jurisdiction over this Adversary Proceeding. Therefore, because Ty Ty cannot succeed on either argument available to it under the consent order allowing a late answer to the counterclaim, the court denies Ty Ty's request for a default judgment.

In reaching the merits of the parties' claims, the court is guided by its order of December 29, 1999. (Doc. 16.) This

order memorializes the agreement of counsel that the court may decide the case based upon the Stipulation of Facts ("Stip."), (Doc. 17), the deposition of Royce Cromer ("Depo."), (Doc. 18), and any admissions in the pleadings. The following will be findings of fact and conclusions of law based upon the evidence before the court as if there had been a complete trial of the case.

FACTS

Royce and Ann Cromer are each 50% shareholders of Cromer Farms, Inc. (Depo. at 5.) Royce Cromer is the Secretary-Treasurer of the corporation, (Depo. at 8), and makes all of the day-to-day decisions regarding the operation of the farm. (Depo. at 79-80.) In June 1998, Ty Ty sued Debtor and Royce Cromer individually. (Stip. ¶ 3.) Debtor admits that on or about August 18, 1998, Debtor executed a note and security agreement that granted to Ty Ty a security interest in all Debtor's inventory, equipment, accounts receivable, livestock, and all crops grown or to be grown on any of its farming operations. The security agreement provided that Debtor would not sell, transfer, lease, or dispose of any of the collateral except with Ty Ty's prior written consent. (Stip. ¶ 2.)

In September 1998, Debtor and Royce Cromer resolved Ty Ty's lawsuit with a confession of judgment, which was an extension, renewal, and refinancing of the August 1998 note.

(Stip. ¶¶ 3, 4.) The confession of judgment is before the court as "Exhibit A" to the Answer and Counterclaim of Defendant, (Doc. 4), and as "Exhibit A-2" to the Stipulation of Facts. (Doc. 17.)

Paragraph 3 of the confession of judgment provides:

> Defendants acknowledge and agree that this agreement is made in order that they may refinance and restructure their obligations and acknowledge and agree that, under all circumstances, that defendants' obligation to repay $60,000.00 shall be and is nondischargeable under the provisions of the Bankruptcy Code of 1978, as amended and codified at 11 U.S.C.A. § 101-1330, and, agree that, if they subsequently file bankruptcy, said obligation shall be deemed nondischargeable as contemplated in 11 U.S.C.A. § 523. Defendants further acknowledge and agree that, should they default in any way in their obligations hereunder, that the entire indebtedness set forth herein, plus interest, shall be nondischargeable.

During negotiations regarding the confession of judgment, Royce Cromer stated, "Everyone will get paid. All I need is some time." (Stip. ¶ 5.) At his deposition, Royce Cromer testified that he understood that under the confession of judgment, any monies received by the farming operation were to go to pay Ashburn Bank for its first lien, and anything left over would be divided 50% to Ty Ty and 50% to other creditors. (Depo. at 17.) Since 1994, however, Ashburn Bank had allowed Mr. Cromer to use some of its funds to pay laborers and other operating and personal expenses without requiring any prior approval, and Mr. Cromer continued this practice. (Depo. at 36-37.)

After the confession of judgment, Ashburn Bank had not been paid back in full, and although Mr. Cromer had paid Ty Ty with some of the money, he stopped paying Ty Ty when they got "nasty" with him. (Depo. at 38.) Debtor and Royce Cromer breached the terms of the confession of judgment by failing to remit to Ty Ty 50% of the farming operation proceeds in excess of Ashburn Bank's lien. (Stip. ¶ 10). These proceeds included F.S.A. payments and disaster payments for 1998 crops received by Debtor after the confession of judgment. (Stip. ¶¶ 14-20.) As of the date of the Stipulation of Facts, Debtor had made no payment to Ty Ty since August 1998. (Stip. ¶ 11.)

Ty Ty now claims that the debt it is owed for the proceeds it should have received under the confession of judgment is nondischargeable under § 523(a)(2)(A), (4), and (6) of the Code. For the reasons that follow, the court finds that the debt is dischargeable under each of these subsections.

DISCUSSION

§ 523(a)(2)(A)

Under Grogan v. Garner, 498 U.S. 279 (1991), Ty Ty has the burden on each of the counts under § 523(a) by a preponderance of the evidence. Ty Ty's argument under § 523(a)(2)(A)is that when Mr. Cromer stated during negotiations for the confession of judgment that everyone would get paid and all he needed was time, Mr. Cromer had no intent at that time to repay everyone,

including Ty Ty. In proving a false representation, Ty Ty must prove that Debtor, through Royce Cromer, misrepresented its intent to pay the debt to Ty Ty. See American Express Travel Related Servs. Co., Inc. v. Rusu (In re Rusu), 188 B.R. 325, 329 (Bankr. N.D. Ga. 1995). Representations regarding a debtor's intentions are actionable only when fraud is proved by showing the debtor had no intention to perform its promise at the time the representation was made. See Kuper v. Spar (In re Spar), 176 B.R. 321, 327 (Bankr. S.D.N.Y. 1994).

Ty Ty has failed to prove by a preponderance of the evidence that, at the time Mr. Cromer, who was the Secretary-Treasurer of Debtor and its de facto chief operating officer, made the statement referred to, he had no intent to repay everyone including Ty Ty. The conduct of Debtor subsequently in not making payments to Ty Ty when it was paying other operating expenses could be considered some evidence that the statement was a false representation known to be false at the time it was made. However, the court does not find that this satisfies the burden of proof. Based upon the evidence, the court finds by a preponderance that Mr. Cromer believed the statement to be true when he made it.

§ 523(a)(4)

Under this subsection, Ty Ty alleges that Debtor embezzled Ty Ty funds by failing to remit proceeds from the

farming operation, and that Debtor committed fraud while acting in a fiduciary capacity. First, Ty Ty has not established that the proceeds were funds of Ty Ty's that could be embezzled. For purposes of this subsection, embezzlement "is the fraudulent appropriation of property of another by a person to whom such property has been entrusted or into whose hands it has lawfully come." Teamsters Local 533 v. Schultz (In re Schultz), 46 B.R. 880, 889 (Bankr. D. Nev. 1985). Under this subsection, Ty Ty must establish that Debtor was not entitled under the law to use the funds as they were used. First State Ins. Co. v. Bryant (In re Bryant), 147 B.R. 507, 512 (Bankr. W. D. Mo. 1992). When debtors use funds to try to keep their business operations functioning, courts hesitate to find the necessary fraudulent intent. Id.

In this case, the receipt of funds after the confession of judgment did not constitute funds of Ty Ty. Debtor was not required to segregate any of the proceeds, and while Debtor's use of the funds to pay operating and some personal expenses violated the agreement with Ty Ty, it was not unlawful in any other sense. Also, Ty Ty has not proved that Mr. Cromer acted with the necessary fraudulent intent. Therefore, the court finds that Debtor did not embezzle the proceeds.

Second, under this subsection, Ty Ty must establish that there was an express trust before Debtor or Royce Cromer can qualify as fiduciaries who may have committed fraud in a

fiduciary capacity. See Davis v. Aetna Acceptance Co., 293 U.S. 328, 333 (1934) (under the Bankruptcy Act of 1841, debtor must have been a trustee before the wrong and without reference thereto; statute refers to technical trusts, not trusts implied from contract); Betz v. Gay (In re Gay), 117 B.R. 753, 754 (Bankr. M.D. Ga. 1989) ("[T]he concept of fiduciary . . . should be narrowly defined and limited in its application to what may be described as technical or express trusts."). The court does not find that Ty Ty's evidence shows an express trust as to the funds that were received by the farming operation after the confession of judgment. Therefore, the debt is dischargeable under this subsection.

§ 523(a)(6)

Under § 523(a)(6), Ty Ty alleges that Debtor willfully and maliciously injured Ty Ty by deliberately expending funds that Ty Ty was entitled to receive. The Supreme Court has ruled that in order to prevail under this subsection, the creditor must establish "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). This exception to discharge requires that the actor intend the consequences, not just the act. Id. at 61-62. A knowing breach of contract will not qualify. Id. at 62.

The evidence in this case shows that Debtor received funds

and paid back some of the crop loan to Ashburn Bank, and used some of the funds for other farm expenses. Mr. Cromer testified that he paid Ashburn Bank some of the money he received from his crops, but also paid some current farm and personal expenses in accordance with the procedure he had followed at Ashburn Bank since 1994. It is undisputed that Debtor had obligated itself to pay Ashburn Bank's current crop loan in full and then to pay 50% of the remaining funds to Ty Ty. Debtor did not do so. However, the court finds that Ty Ty has not carried its burden to show that this failure was with intent to injure Ty Ty or its property. Therefore, the court finds that Ty Ty has failed to carry the burden as to the nondischargeability of this debt under subsections 523(a)(2)(A), (4), and (6).

Collateral Estoppel

Finally, Ty Ty argues that the language regarding nondischargeability in the confession of judgment collaterally estopps Debtor from asserting the dischargeability of Ty Ty's debt. It is important to note that the confession of judgment contains only legal conclusions and has no findings of fact to support nondischargeability.

The court is guided by the Eleventh Circuit's decision in Halpern v. First Georgia Bank (In re Halpern),810 F.2d 1061 (11th Cir. 1987). The facts in Halpern are similar to the

facts in this case, but in Halpern, the consent judgment at issue contained detailed findings of fact that contained all the elements necessary for a § 523(a)(2)(A) claim. Id. at 1063. The court in Halpern's decision to apply collateral estoppel to the admitted facts, which it then considered as evidence of nondischargeability, was affirmed by both the district court and the Eleventh Circuit.

In this case, however, there are only bare conclusions of law that the debt is nondischargeable. Such conclusions are not binding on this court. See id. at 1063-64 (distinguishing between findings of fact in state court consent judgment, which may be entitled to preclusive effect, and ultimate issue of nondischargeability, which is exclusively for the bankruptcy court to determine). As Judge Kahn stated in his opinion below, "[T]hose provisions of the consent order in which [debtor] promised to forgo a discharge and agreed that the debt was nondischargeable are completely without legal effect." First Georgia Bank v. Halpern (In re Halpern), 50 B.R. 260, 262 (Bankr. N.D. Ga. 1985), aff'd, 810 F.2d 1061 (11th Cir. 1987). Accordingly, the court finds that collateral estoppel does not apply to the assertion of nondischargeability in the confession of judgment.

CONCLUSION

First, the court finds that Ty Ty has not presented the

evidence necessary to entitle it to a default judgment under the wording of the consent order allowing a late-filed answer to the counterclaim. Second, under § 523(a)(2)(A), (4), and (6), the court finds that Ty Ty has not carried its burden of proof and therefore the debt is dischargeable. Finally, the court finds that collateral estoppel does not apply to the conclusion of nondischargeability in the confession of judgment.

Accordingly, the court will enter a judgment in favor of the Plaintiff-Debtor on this counterclaim. Because the main action has been dismissed with prejudice, this Adversary Proceeding is now concluded. Each party will bear its own costs. An order will be entered in accordance with this Memorandum Opinion.

DATED this 18th day of July 2000.

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JOHN T. LANEY, III
UNITED STATES BANKRUPTCY JUDGE