

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF OHIO
EASTERN DIVISION**

In re: Case No. 02-63857 :

Regina H. Duffey, :

Debtor. :

KeyBank National Association, :

Plaintiff, : **Adversary No. 03-2146**

V. : Chapter 7 (Judge Caldwell)

Regina H. Duffey, :

Defendant. :

MEMORANDUM OPINION AND ORDER

This Memorandum Opinion and Order constitute the findings of fact and conclusions of law for the adversary proceeding commenced by KeyBank National Association (“Plaintiff”), against Regina H. Duffey (“Defendant”). The Plaintiff seeks a nondischargeability determination under Section 523(a)(6) of the United States Bankruptcy Code (“Code”). The Court has concluded that the Plaintiff has failed to meet its burden by a preponderance of the evidence. A brief history will illustrate the bases for this decision.

The Defendant received a Bachelors of Science in Business Administration from Franklin University in 1982. She opened Noritech, Inc. (“Noritech”) in 1988, and it was incorporated in 1994. The Defendant was the president and sole shareholder of Noritech, which sold computers and related services, primarily to the State of Ohio. The Defendant also operated a sole proprietorship, Business Technology Center (“Business Tech Center”), that was in operation from February 2000 to July 2002. According to

the Defendant, Business Tech Center trained purchasers to use the equipment or software sold by Noritech. The record indicates that Noritech had gross income of approximately \$2.5 Million in the year 2000, and approximately \$3.1 Million in 2001. The Defendant testified that her sole source of income was from Noritech.

During Noritech's operation, the Defendant received commercial loans from three banks. First, in 1992, Noritech borrowed approximately \$300,000.00 from the National Bank of Detroit ("NBD"). The NBD loan was secured by Noritech's accounts receivable, and was personally guaranteed by the Defendant. Second, between 1994 and 1995, Noritech received a loan from Bank One, in the amount of \$500,000.00. The Bank One loan was secured by Noritech's accounts receivable, and was personally guaranteed by the Defendant. Finally, in July 1999 Noritech borrowed \$900,000.00, from the Plaintiff on a revolving line of credit. The accounts receivables of Noritech were pledged as security, and the debt was guaranteed by the Defendant. In August 2001 the \$900,000.00 loan was restructured.

The Defendant testified that the State of Ohio, her principal client, issued a moratorium on all spending after September 11, 2001. This resulted in a reduction in sales, and Noritech's business declined in early 2002. The Defendant prepared an Accounts Receivable Aging Summary for Noritech as of April 11, 2002, ("Aging Summary"), which identified receivables totaling \$210,968.16. According to the Defendant, less than \$50,000.00 in accounts receivables were generated after April 11, 2002. The Defendant testified that all of the accounts receivables reflected on the Aging Summary were ultimately collected.

On May 2, 2002, the Plaintiff sent a Notice of Default (“Default Notice”), to Noritech, and demanded payment in the amount of approximately \$900,000.00. The Defendant testified, however, that there was nothing in the Default Notice that caused her to believe that she was to immediately pay over accounts receivable proceeds. Indeed, the Default Notice makes no reference to the receivables. On May 5, 2002, the Defendant made a payment of \$5,000.00, to A.C. Strip, Esq., her bankruptcy counsel. Between May 2, 2002, and May 29, 2002, Mr. Strip provided notice to the Plaintiff of Noritech’s anticipated closure. In response, on May 29, 2002, the Plaintiff sent Mr. Strip a letter in which arrangements for the liquidation of the business assets were discussed, and the Plaintiff requested a list of all receivables, including the addresses and phone numbers, in order to begin collections.

On May 31, 2002, the Plaintiff sent a second letter to Mr. Strip, that in addition to reiterating previous instructions regarding the receivables, also stated that the Plaintiff expected, “. . . that any funds that [the Defendant] collect[ed] from these receivables will be turned over to the Bank promptly . . .” In this letter the Plaintiff also discussed its plans to mail sale notices to dispose of the business assets. The Defendant testified that this was the first time that she was aware that the Plaintiff requested turnover of the accounts receivable proceeds. Between May 31, 2002, and June 6, 2002, the Defendant provided KeyBank with a list of accounts receivable as of September 30, 2001, totaling \$1,254,096.00. The Defendant also provided KeyBank with the Aging Summary, and copies of purchase orders totaling approximately \$100,000.00.

According to the Defendant, Noritech began to wind down its operations in early 2002, and was closed by June of 2002. During this period the Defendant requested additional financing from the Plaintiff. The request was premised upon her efforts to salvage the business by bidding on some contracts with the State of Ohio. The Plaintiff sent two representatives to discuss the Defendant's request, but it was denied. The Defendant testified that the financing was denied because the accounts receivable balances were not high enough, and Noritech was insolvent.

On June 6, 2002, the Plaintiff, sent Mr. Strip a third letter, which requested that any receivables that the Defendant collected be segregated and forwarded to the Plaintiff immediately, along with an accounting. The June 6, 2002, letter, further instructed Mr. Strip that the Plaintiff's loan documents and applicable Ohio statutes prohibited the use of the accounts receivable proceeds, "... other than in the ordinary course of business, without the (Plaintiff's) consent . . ." (emphasis supplied). The Defendant testified that her understanding of the June 6, 2002, letter, was that the Plaintiff was permitting her to pay the items that were necessary in the ordinary course of business, and then forward the excess to KeyBank. The Defendant testified, however, that she did not turn over the requested information or any of the accounts receivable proceeds.

The Defendant testified that instead she used the accounts receivable proceeds to pay her employees' salaries, retirement, taxes, sales commissions, and vacation time. She also testified that she used the proceeds to pay creditors of Business Tech Center, and Noritech's rent. The Defendant testified that she spent at least \$20,000.00 on personal expenses, including rent, mortgage and automobile payments, gas and light bills. According to the Defendant this sum constituted back wages. As detailed in the Statement of Financial Affairs, Noritech was the Defendant's primary source of income around the

petition date, and the Defendant collected only \$5,236.00 in unemployment from June 8, 2002, through September 27, 2002. The Defendant testified that she did not pay the Plaintiff, because of the large size of the balance.

On July 1, 2002, the Plaintiff, filed suit in the Common Pleas Court for Franklin County, Ohio. Default judgments on the Notes and the Guarantees were entered in the amount of approximately \$900,000.00 on September 12, 2002. The Defendant filed the instant case under Chapter 7 of the United States Bankruptcy Code on, October 21, 2002. On that same date the Defendant registered the trade name, “Noritech Enterprises”, with the Ohio Secretary of State’s Office. Approximately one year later on October 16, 2003, the Defendant incorporated, “Noritech Enterprises, Inc.” The Plaintiff filed the present complaint, seeking a nondischargeability determination under section 523(a)(6) of the Code, on April 4, 2003.

Turning to the applicable legal standard, Section 523(a)(6) of the Code provides that a discharge, “. . . does not discharge an individual debtor from any debt . . . for willful and malicious injury by the debtor to another entity or to the property of another entity . . .” For a debt to be non dischargeable, the moving party must show willful and malicious injury by a preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 291 (1991). The actor must have intended the consequences of an act, rather than the act itself. Kawauhau v. Geiger, 523 U.S. 57, 61-62 (1998). Willful means deliberate or intentional, and requires something more than mere negligence or recklessness. Kawauhau v. Geiger, at 61.

Courts in the Sixth Circuit, following the guidance of the Supreme Court, have found that Section 523 (a)(6) of the Code requires that the creditor show an intent to cause harm or substantial certainty that the harm will follow. See, e.g., Markowitz v. Campbell (In re Markowitz), 190 F.3d 455, 464 (6th Cir.

1999); Salem Bend Condominium Association v. Bullock-Williams (In re Bullock-Williams), 220 B.R. 345, 347 (6th Cir. B.A.P. 1998); Redmond v. Finch (In re Finch), 289 B.R. 638, 644 (Bankr. S.D. Ohio 2003); Beard v. Devore (In re Devore), 282 B.R. 643, 645 (Bankr. S.D. Ohio 2002);

As in the instant case where it has been alleged that debtors have failed to turn over proceeds, it has been concluded that the obligations are dischargeable, when: 1) The lender fails to establish that the debtor retained the proceeds with the intent to harm the lender, even though the debtor may have acted negligently or recklessly; 2) The debtor used the proceeds in the ordinary course of business to preserve the value of the business, for future sale, or to maintain it as an ongoing enterprise; and 3) The debtor did not understand that use of the proceeds to maintain its business was a breach of the security agreement.

Florida Outdoor Equipment, Inc. v. Tomlinson (In re Tomlinson), 220 B.R. 134, 137-138 (Bankr. M. D. Fla. 1998); National City Bank, Northwest v. Wikel (In re Wikel), 229 B.R. 6, 9-11 (Bankr. N.D. Ohio 1998); Mayfield Grain Co., Inc. v. Crump (In re Crump), 247 B.R. 1, 4-7 (Bankr. W.D. Ky. 2000).

Courts in the bankruptcy context have defined, “ordinary course of business”, as activities that are a part of the day-to-day operations or maintenance of a business, including routine trade credit transactions, such as the payment of monthly utility bills. See, e.g., The Committee of Asbestos-Related Litigants And/Or Creditors v. Johns-Manville Corp. (In re Johns-Manville Corp.), 60 B.R. 612, 618 (Bankr. S.D.N.Y. 1986); U.S. ex rel. Harrison v. Estate of Deutscher (In re H & S Transportation Co., Inc.), 115 B.R. 592, 598 (D.M.D. Tenn. 1990); Johnston v. First Street Companies and Wirth (In re Waterfront Companies, Inc.), 56 B.R. 31, 35 (Bankr. D. Minn. 1985); Jobin v. McKay (In re M & L Business Machine Co., Inc.), 164 B.R. 657, 664 (D. Colo. 1994). Establishing whether a transaction occurred in the ordinary course of business, does not require “. . . an extensive showing that such

transactions occurred often, or even regularly . . . it need only be ordinary...” Johns-Manville, 60 B.R. at 618 (quoting Campbell v. Cannington (In re Economy Milling Co., Inc.), 37 B.R. 914, 922 (D.S.C. 1983)).

In the dischargeability context lenders also have an obligation to protect their security interests upon default. Factors that have been considered include: 1) Whether the security agreement gave the debtor adequate notice of the permitted and/or prohibited uses of the collateral; 2) Whether the creditor required that the proceeds be segregated; 3) Whether the creditor took any action when its periodic inspections revealed that the proceeds had not been remitted pursuant to the security agreement; 4) Whether the creditor continued to advance funds after default; and 5) Whether the creditor acquiesced in the conduct. Tomlinson, 220 B.R. at 138; Crump, 247 B.R. at 6.

This Court has concluded that the Plaintiff has failed to sustain its burden by a preponderance of the evidence. First, the Plaintiff did not provide any testimony from its employees that dealt with the Plaintiff. Instead, the Plaintiff relied solely upon the testimony of the Defendant, whose memory is not clear, apparently due to a stroke. In particular, it would have been helpful in establishing intent to hear from the employee who drafted the Default Notice and the three letters detailed above, as well as the two representatives that visited Noritech when the Defendant requested additional funding.

There is no testimony from the Plaintiff’s employees as to why more aggressive collection action was not taken in May or June 2002, before the proceeds were expended. The Plaintiff presumably knew that the Defendant was experiencing financial difficulty as early as August 2001

when it restructured the obligations. When the Plaintiff was informed of the anticipated closure of

Noritech, it could have acted to intercept the proceeds via a lockbox or other means.

Second, the Plaintiff seeks to paint a picture of a debtor that is dishonest, and that is out to punish the Plaintiff for not extending additional credit. In support of this theory the Plaintiff elicited testimony regarding a criminal conviction of the Defendant, that the Defendant paid her bankruptcy attorney \$5,000.00 days after the Default Notice, that the Defendant sought to form new business entities, and that the Defendant used some of the proceeds to pay personal expenses, Noritech rent and the obligations of Business Tech Center. The Court does not find these factors persuasive.

The criminal proceeding was instituted by a scheduled creditor who failed to file a complaint to determine dischargeability. It is unclear whether the issue of the discharge of this obligation was ever properly raised. The new trade name was not registered in May when the Default Notice was issued or before, but rather on the day of the bankruptcy filing. A new entity was not incorporated until almost a year after the bankruptcy filing. Such timing does not suggest to the Court a debtor that was planning, along with her counsel, to take the accounts receivable proceeds and continue doing the same business under a different name. Instead, it suggests a debtor that was trying to exercise the right to have a livelihood after bankruptcy.

The alleged scheme to deprive the Plaintiff of its proceeds is not consistent with the facts. It was the Defendant that, through her Counsel, gave the Plaintiff notice of her anticipated closure. The Defendant maintained and provided to the Plaintiff the Aging Summary, along with copies of purchase orders in the approximate amount of \$100,000.00. There is no indication in the record that there was any attempt to hide the closure or to falsify information with reference to the receivables. Rather, the Court sees the Defendant as a debtor that used accounts receivables proceeds in a manner that may be inconsistent with

the loan documents. This asserted misuse, however, is not sufficient to establish willful and malicious injury.

The Defendant was engaged in efforts to wind down the business operations, while at the same time trying to find the means to bid on additional contracts. The June 6, 2002, correspondence from the Plaintiff could be read to consent to the use of the proceeds to pay, “ordinary course of business” expenses. Certainly, a more direct statement that there should be no further use after the issuance of the Default Notice and more assertive action may have been taken. The Court cannot find an intent to harm the Plaintiff where the proceeds were used to fund payroll and payroll-related expenses and other expenses associated with the Defendant’s two related businesses, all of which appear to be ordinary course of business transactions to the Court.

It is true that the Defendant used approximately \$20,000.00 of the proceeds to defray her personal expenses. Noritech, however, was the Defendant’s primary source of income, as is supported by the Statement of Financial Affairs. There, the Defendant reported income/salary as \$65,955.00 for the year 2000, \$61,151.00 for the year 2001, and her year to date income through May 16, 2002, as \$16,110.00. Given this information, the sum of \$20,000.00 that was used by the Defendant appears consistent with the salary taken from Noritech during the two years prior to the filing. The payment of Noritech rent is an expense typically incurred by businesses that are being closed in an orderly fashion. Indeed, the May 29, 2002, correspondence from the Plaintiff suggests that it was seeking at that point to sale the business assets while on location in the leased premises. Regarding the payment of expenses of Business Tech Center, it was controlled by the Defendant, and it provided services that were complimentary to Noritech.

The Defendant is well-educated, experienced in business, including entering into commercial loans,

and was apparently capable of understanding the consequences of the use of the receivables. It is the finding of this Court, however, that she was faced with the Hobson's choice of using the proceeds for the payroll, rent and other business related expenses or instead using them to pay toward the very large balance owed the Plaintiff. These facts, however, are not sufficient to establish the requisite intent. Accordingly, the Court has concluded that the Plaintiff has failed to meet its burden under section 523(a)(6) of the Code.

IT IS SO ORDERED.

Date: _____

Charles M. Caldwell
United States Bankruptcy Judge

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