UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF SOUTH CAROLINA

IN RE:

James R. Pasco and Cathy L. Pasco,

Debtors.

G. Kevin Youmans and Dawn Youmans,

Plaintiffs,

v.

James R. Pasco and Cathy L. Pasco,

Defendants.

C/A No. 97-04421-W

Adv. Pro. No. 97-80289-W

JUDGMENT

Chapter 7

Based upon the Findings of Fact and Conclusions of Law as recited in the attached Order of the Court, the Plaintiffs motion for summary judgment as well as the Defendants motion for summary judgment shall be denied. In regards to the trial in this matter, judgment shall be entered in favor of the Defendants/Debtors and the debt to the Plaintiffs shall not be excepted from discharge pursuant to 11 U.S.C. § 523(a)(4) or § 523(a)(6).

UNITED STATES BANKRUPTCY JUDGE

Columbia, South Carolina,
October 28, 1998.

52

CERTIFICATE OF MAILING

The undersigned deputy clerk of the United States Bankruptcy Court for the District of South Carolina hereby certifies that a copy of the document on which this stamp appears was mailed on the date listed below to:

OCT 29 1998

~~DEBTOR, DEBTOR'S ATTORNEY, TRUSTEE~~

LISA BAUGHMAN

Deputy Clerk

Denton
Fairbanks
3 to chambers

UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF SOUTH CAROLINA

IN RE:

James R. Pasco and Cathy L. Pasco,

Debtors.

G. Kevin Youmans and Dawn Youmans,

Plaintiffs,

v.

James R. Pasco and Cathy L. Pasco,

Defendants.

C/A No. 97-04421-W

Adv. Pro. No. 97-80289-W

ORDER

Chapter 7

THIS MATTER came before the Court for trial upon the Plaintiffs complaint seeking a determination of dischargeability of a particular debt pursuant to 11 U.S.C. § 523(a)(4) and § 523(a)(6)[1] and upon the motion for summary judgment filed by the Plaintiffs G. Kevin Youmans ("Mr. Youmans") and Dawn Youmans ("Ms. Youmans") and the motion for summary judgment filed by the Defendants James R. Pasco ("Mr. Pasco") and Cathy L. Pasco ("Ms. Pasco").

At the hearing on the motions for summary judgment, the Plaintiffs withdrew the allegations pursuant to § 523(a)(6) and also voluntarily dismissed Ms. Pasco as a Defendant to this adversary proceeding. Additionally, the parties stipulated to certain factual findings, stipulated to the introduction of affidavits of Ms. Youmans and Mr. Pasco and stipulated that if the Court could not make a determination on the motions for summary judgment, the Court could

[1] Further references to the Bankruptcy Code, 11 U.S.C. § 101 *et seq.*, shall be by section number only.

rely upon the affidavits of Mr. Pasco and Ms. Youmans and certain exhibits that were introduced into the record by stipulation for the trial.[2] Therefore, receiving the affidavit testimony, considering the pleadings and stipulated evidence, the Court adopts the parties' Stipulation of Facts as stated in their joint pre-trial order and makes the following Conclusions of Law pursuant to Rule 52 of the Federal Rules of Civil Procedure, made applicable by Rule 7052 of the Federal Rules of Bankruptcy Procedure.[3]

STIPULATION OF FACTS

Atlantic Sprinkler Systems, Inc. ("ASSI") was incorporated by Mr. Pasco and Mr. Youmans in South Carolina as a statutory close corporation on January 31, 1991. The parties stipulate that at all times relevant to this adversary proceeding Mr. Pasco was president and Mr. Youmans was vice-president and secretary of ASSI. Mr. Youmans was the holder of the South Carolina Sprinkler License, a legal prerequisite to operating as a "fire protection sprinkler contractor" in South Carolina. South Carolina Code Ann. §§ 23-45-10 *et seq.* (1976, as amended). Mr. Pasco and Mr. Youmans were the sole shareholders, with each holding 50% of the shares, and also functioned as directors of the corporation.

ASSI was in the business of designing, installing, and maintaining fire protection sprinkler systems. Operations began in February, 1991. Within a short period of time, ASSI achieved a significant volume of business, primarily military, state, and federal government projects.

---

[2] While the Plaintiffs rely upon equitable estoppel principals, they abandoned their position that res judicata or collateral estoppel should be applied to the previous State Court judgments.

[3] The court notes that to the extent any of the following Findings of Fact constitute Conclusions of Law, they are adopted as such, and to the extent any Conclusions of Law constitute Findings of Fact, they are so adopted.

In consideration of the issuance of certain surety bonds (contractor performance bonds) by Indiana Lumbermans Mutual Insurance Company ("Bonding Company"), Mr. Pasco, Mr. Youmans, and their wives, executed a General Agreement of Indemnity on January 13, 1992 (the "Indemnity Agreement"). The Indemnity Agreement provided *inter alia*, that the indemnitors would perform all conditions of any surety bonds issued pursuant to it, and would indemnify and hold the Bonding Company harmless from all claims, losses, and costs, payable on demand of the Bonding Company. Pursuant to the Indemnity Agreement, the Bonding Company issued performance bonds in connection with certain contracts entered into by ASSI, including the following:

1) On or about July 16, 1991, ASSI entered into a subcontract with Primesouth, Inc. for the installation of a sprinkler system at the Greenville Detention Center; and on or about February 12, 1992 the Bonding Company issued its Performance Bond for said project.
2) On or about November 1, 1991, ASSI entered into a subcontract with Dargan Construction Company for the installation of a sprinkler system at the South Carolina State College; and on or about June 25, 1992 the Bonding Company issued a Performance Bond for said project.
3) On or about February 6, 1992, ASSI entered into a subcontract with C.B. Askins & Co. for the installation of a sprinkler system at the Florence County Law Enforcement Center; and on or about June 30, 1992 the Bonding Company issued its Performance Bond for said project.

Conflicts arose between Mr. Pasco and Mr. Youmans, and by letters dated March 11, 1992 from Mr. Youmans to the licensing boards of South Carolina and Georgia, notice was given that Mr. Youmans was no longer in the employ of ASSI. By letter dated March 13, 1992 to ASSI, Mr. Youmans gave notice that his sprinkler contractor's license was withdrawn from ASSI and that he was no longer the qualified representative of the company, but that he was not prohibited from discussing technical aspects of work in progress with owners, contractors, or

anyone else who may have need of such information, even though he would in no way be representing ASSI when such matters are discussed. After March 11, 1992, Mr. Youmans did not participate in the management of ASSI. However, Mr. Youmans did not deliver a notice to ASSI that he resigned as an officer or director of the corporation.

Mr. Pasco continued to operate ASSI after being notified that Mr. Youmans had withdrawn his license. It was Mr. Pasco's understanding, based on conversations with the State Licensing Board, that ASSI could continue to operate to complete pending contracts. A letter from the City of Greenville dated March 20, 1992 indicates that the State License Board would allow ASSI six months in which to have someone licensed with its company, and that ASSI would be allowed to finish permitted work in progress even if it decided to drop its State License status.

In early 1993, the Bonding Company was notified that ASSI was not performing under the terms of the subcontracts. The Pascos admit that ASSI defaulted in its performance under certain contracts. There is a dispute as to the cause of the defaults and as to the relevance of any such cause.

During April, 1993, the parties received notices from the Bonding Company that certain contracts were in default and that claims were being made against the bonds. The Bonding Company requested the parties' assistance in responding to the claims. Demand was made for payment of sums necessary to complete the contracts. Additionally, demands were made upon the parties to produce the books and records of ASSI, so that the status of the work under the contracts might be determined. Mr. Pasco provided some information to the requests for information, but it was not to the extent that he could or should have responded.

On June 4, 1993, Mr. and Mrs. Pasco filed Chapter 11 Bankruptcy, Case No. 93-72819.

On April 14, 1994 the case was dismissed pursuant to Local Rule 1112.

On June 12, 1995, the Bonding Company filed suit against ASSI and all indemnitors seeking damages under the terms of its performance bonds. ASSI and the Pascos failed to respond to the Complaint and were held in default. Mr. Pasco made the decision not to answer the complaint on behalf of ASSI. On August 15, 1996, default judgment was entered against ASSI and the Pascos in the amount of $297,309.65.

The Youmans answered the Complaint and cross-claimed against ASSI and the Pascos alleging the latters' intervening negligent or intentional acts. Neither the Pascos nor ASSI responded or appeared in connection with the Youmans' answer and cross-claim. Having in the meantime settled with the Bonding Company for $55,000.00, the Youmans thereafter obtained an Order of Judgment (for indemnity), dated April 23, 1997 against the Pascos and ASSI for said sum, plus attorneys fees of $9,000.00, for a total judgment in the sum of $64,000.00.

On May 23, 1997, Mr. and Mrs. Pasco filed Chapter 7 Bankruptcy, Case No. 97-04421-W, and the estate was declared to have no assets. The Youmans commenced this Adversary Proceeding September 9, 1997.

CONCLUSIONS OF LAW

Section 523(a)(4) of the Bankruptcy Code states that a discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt--(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny. 11 U.S.C. § 523(a)(4). As the Plaintiff has stipulated that the acts of the Debtor did not involve fraud, embezzlement or larceny, the sole remaining allegation in the complaint pending before this Court is whether Mr. Pasco committed defalcation while acting in a fiduciary capacity.

Therefore, the Court must address two prongs of § 523(a)(4); first, was Mr. Pasco operating in a fiduciary capacity and second, if Mr. Pasco was operating in a fiduciary capacity, did those acts amount to defalcation.

A. Fiduciary Capacity

Mr. Youmans asserts that Mr. Pasco's direct and indirect breach of his fiduciary duties to Mr. Youmans was the cause of Mr. Youman's liability to the Bonding Company. Directly, Mr. Youmans asserts that Mr. Pasco's failure to assist in the defense of the litigation with the Bonding Company proximately caused his liability arising from the Indemnity Agreement. Indirectly, Mr. Youmans asserts the he would not have incurred the liability to the Bonding Company if Mr. Pasco had not breached his duty to Mr. Youmans as a co-officer and director to properly manage the business operations of ASSI. Mr. Pasco denies that he owed a fiduciary duty to Mr. Youmans, either directly or indirectly.

The definition of "fiduciary" in bankruptcy is a matter of federal law although state law is important in determining when a trust relationship exists. In re Martin, 161 B.R. 672 (Bkrtcy. App. Panel 9th Cir. 1993) and In re Kraus, 37 B.R. 126, 128 (Bkrtcy. E.D. Mich. 1984). The definition of fiduciary has been strictly construed in the Fourth Circuit.

> Turning first to the question of fiduciary status, we note that the term "fiduciary" has been "strictly construed" in the context of dischargeability of debt determinations under 11 U.S.C. § 523(a)(4). In re Duiser, 12 B.R. 538, 539 (W.D.Va.1981). The necessary relationship must arise from a preexisting express or technical trust. In re Murphy, 9 B.R. 167, 173 (E.D.Va.1981). That is, "[i]t is not enough that by the very [alleged] act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee ex maleficio. He must have been a trustee before the wrong and without reference thereto." Davis v. Aetna Acceptance Co., 293 U.S. 328, 333 (1934). See

> also 3 Collier on Bankruptcy, § 523.14[1][c], at 523-10612 (15th ed. 1991).

Bradley v. Kelley, 948 F.2d 1281 (4th Cir. 1991)(Unpubl.).[4] Also see In re Owens, 54 B.R. 162 (Bkrtcy.D.S.C. 1984) (aff'd at Owens v. Landvest Assoc., 2:84-2743-8 (D.S.C. 9/18/85).

Pursuant to this strict construction, it does not appear that a fiduciary relationship existed between Mr. Pasco and Mr. Youmans based upon their obligations as co-indemnitors with the Bonding Company. While there may have been contractual obligations between the parties, there was no relationship of trust between them.

> For purposes of section 523(a)(4), the definition of "fiduciary" is narrowly construed, meaning that the applicable state law that creates a fiduciary relationship must clearly outline the fiduciary duties and identify the trust property; if the state law does not clearly and expressly impose trust-like obligations on a party, the court will not assume that such duties exist and will not find that there was a fiduciary relationship.
>
> The mere fact that state law places two parties in relationship that may have some of the characteristics of a fiduciary relationship does not necessarily mean that the relationship is a fiduciary relationship under 11 U.S.C. § 523(a)(4), which requires the existence of express or technical trust. As one court has observed:
>
> > [C]ase authority recognizes that the traditional definition of "fiduciary" is not applicable in defining "fiduciary capacity" under section 523(a)(4). The general meaning of a fiduciary -- a relationship involving confidence, trust and good faith -- is far too broad for the purposes of section 523(a)(4) ... . The Supreme Court favors a narrow construction of the term "fiduciary capacity" and defines the term as meaning arising from an express or technical trust.

---

[4] Although unpublished Fourth Circuit opinions are not binding precedent (I.O.P 36.5 and 36.6), they may supply "helpful guidance". In re Serra Builders, Inc., 970 F. 2d 1309, 1311 (4th Cir. 1992).

4 Collier on Bankruptcy, ¶ 523.10[1][c] (15th ed. rev. 1997) citing In re Twitchell, 91 B.R. 961, 964-65 (D.Utah 1988), citing Davis v. Aetna Acceptance Co., 293 U.S. 328, 333, 55 S.Ct. 151, 153 (1934). As there was no express or technical trust arising from the Indemnity Agreement, the Court finds that there was no fiduciary relationship between Mr. Youmans and Mr. Pasco as co-indemnitors and therefore need not address whether the actions, or inactions, of Mr. Pasco in failing to fully cooperate with the Bonding Company rose to the level of defalcation .[5] However, as corporate officers and directors of ASSI, the situation is different.

The Fourth Circuit Court of Appeals in applying South Carolina law has stated the degree of the fiduciary relationship between directors of a corporation and stockholders.

> In order to understand the basis for such, we must delineate the duties of directors. In Koehler v. Black River Falls Iron Co., 67 U.S. (2 Black) 715, 720, 17 L.Ed. 339 (1862), the Court said that directors "hold a place of trust and by accepting the trust are obliged to execute it with fidelity, not for their own benefit, but for the common benefit of the stockholders of the corporation."

F.D.I.C. v. Sea Pines Company, 692 F.2d 973 (4th Cir. 1982). Additionally, promoters of a corporation owe a fiduciary duty to each other, Bivens v. Watkins, 313 S.C. 228, 437 S.E.2d 132 (S.C. 1993) and in statutory close corporations such as this one, the actions of the managing director of the corporation could result in a breach of fiduciary duty to the minority shareholder if full disclosure is not given.

> Here, the circumstances involved a person who had a fiduciary duty to disclose all relevant facts affecting the value of a corporation,

---

[5] The Plaintiffs also took the position that if there was a fiduciary duty arising from the Indemnity Agreement, Mr. Pasco should be equitably estopped from asserting a defense to the verdict at this time after remaining silent during the state court litigation. However, as the Court has found no fiduciary relationship from the Indemnity Agreement, the Court need not address the equitable estoppel argument.

> i.e., a corporation's president and manager selling stock in the corporation to other shareholders. See Manning v. Dial, 271 S.C. 79, 245 S.E.2d 120 (1978) (as the managing officer of a corporation, the defendant-stockholder had a fiduciary duty to disclose all relevant facts to the plaintiff, the only other stockholder, when purchasing the plaintiff's stock); Jacobson v. Yaschik, 249 S.C. 577, 155 S.E.2d 601 (1967) (a defendant, who was president, general manager, majority stockholder, and director of a corporation, stood in a fiduciary relationship to the plaintiff, the only other stockholder, and in every instance was required to make a full disclosure of all relevant facts when purchasing the plaintiff's stock).

Epstein v. Howell, 308 S.C. 528, 419 S.E. 2d 379 (S.C.App. 1992). Also see Butler, Bankruptcy Handbook, ¶ 16.57(a) at p. 162-42 (1998).

While Mr. Pasco may have owed a fiduciary duty to Mr. Youmans, the Court need not conclude such a determination at this time because, as will be discussed below, it does not appear that the actions of Mr. Pasco involved defalcation.[6]

B. Defalcation

The Bankruptcy Code does not define the term defalcation. An opinion from the Bankruptcy Court for the Northern District of Oklahoma conducted an exhaustive review of the case law and chose to follow the definition supplied by Judge Learned Hand that defalcation "implies some moral dereliction" citing Central Hanover Bank & Trust Co. v. Herbst, 93 F.2d 510 (2d Cir. 1937).

> Unlike the case law under the Bankruptcy Act, the court interpreting the scope of defalcation under the Bankruptcy Code are in agreement on several points. First, defalcation is the failure

---

[6] In order to make the determination of defalcation, the Court must review the totality of the circumstances and therefore must review the documentary evidence in addition to the affidavit testimony. For this reason, the Court will deny both of the motions for summary judgment.

> to account for money or property that has been entrusted to one. See, In re Wolfington, 48 B.R. 920, 923 (Bkrtcy.E.D.Pa.1985); In re Owens 54 B.R. 162 [(Bkrtcy.D.S.C.1984)]; In re Cowley, 35 B.R. 526 (Bkrtcy.D.Kan.1983); In re Waters, 20 B.R. 277 (Bkrtcy.W.D.Tex.1982). Second, defalcation is a broader term than either embezzlement or misappropriation. See In re Wolfington, supra; In re Weaver, 41 B.R. 649 (Bkrtcy.W.D.Okla.1984); In re Cowley, supra; In re Waters, supra. Third, defalcation is evaluated by an objective standard and no element of intent or bad faith need be shown. See In re Gonzales, 22 B.R. 58 (Bkrtcy. 9th Cir.1982); American Ins. Co. v. Lucas, 41 B.R. 923 (D.W.D.Pa.1984); Martino v. Brown, 34 B.R. 116 (D.N.M.1983); In re Petersen, 51 B.R. 486 (Bkrtcy.D.Kan.1985); In re Gagliano, 44 B.R. 259 (Bkrtcy.N.D.Ill.E.D.1984); In re Waters, supra.
>
> > ... For example, the court in Cowley wrote that defalcation "is the slightest misconduct, and it may not involve misconduct at all. Negligence or ignorance may be defalcation." 35 B.R. at 529.
>
> . . .
>
> Bankruptcy purposes would actually be best served if "fiduciary capacity" were read broadly (in the manner of the 10th Circuit Court in Devery Implement Co. v. J.I. Case Co., supra) while "defalcation" were read narrowly (as by Judge Learned Hand in Central Hanover Bank & Trust Co. v. Herbst, supra). This would allow most confidential relationships the benefit of protection, but would limit such protection (and the corresponding penalty to debtors) to the more heinous breaches of such confidences. This would except from discharge most "dishonest" debts, and discharge most "honest" ones.
>
> This Court agrees with Judge Learned Hand that "the authorities are not indeed very satisfactory." The most satisfactory of the lot is Judge Learned Hand's own opinion in Central Hanover Bank & Trust Co. v. Herbst, which this Court will attempt to follow.

In re Turner, 134 B.R. 646 (Bkrtcy.N.D.Okl. 1991).

With a respect of the broad spectrum of definitions of defalcation, at a minimum it does require some degree of misconduct, negligence or ignorance. Based upon a review of the Stipulation of Facts, the exhibits and the affidavits of Mr. Youmans and Mr. Pasco, it does not

appear that Mr. Pasco misconducted the business affairs of ASSI after Mr. Youman's departure to a degree to rise to the level of defalcation. It does not appear that Mr. Pasco was unjustified in completing work without a license, in fact, he may have mitigated some of the damages by attempting to complete the work. Additionally, in weighing the evidence, it appears that Mr. Youmans was involved in entering into and procuring the contracts and there was no clear evidence that the contracts were feasible or profitable from the outset. Also, it was not shown that Mr. Pasco kept Mr. Youmans out of the company or refused him access to the books and records of ASSI or misappropriated any funds entrusted to him as the officer of ASSI.

In these situations, the Court must look to the standard of proof. A creditor seeking to have a debt excepted from discharge must prove the nondischargeability of the debt by a preponderance of the evidence. Grogan v. Garner, 498 US 279, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991); Combs v. Richardson, 838 F.2d (4th Cir. 1988). In this case, it is the finding of the Court that even if Mr. Pasco owed a fiduciary duty to the Youmans, the Youmans have failed to present sufficient evidence that Mr. Pasco acted with defalcation in the performance of these duties.

For this reason, judgment shall be entered in favor of the Debtors and the debt to the Plaintiffs shall not be excepted from discharge pursuant to 11 U.S.C. § 523(a)(4).

AND IT IS SO ORDERED.

John E. Waites
UNITED STATES BANKRUPTCY JUDGE

Columbia, South Carolina,
October 28, 1998.

CERTIFICATE OF MAILING

The undersigned deputy clerk of the United States Bankruptcy Court for the District of South Carolina hereby certifies that a copy of the document on which this stamp appears was mailed on the date listed below to:

OCT 29 1998

~~DEBTOR~~, ~~DEBTOR'S ATTORNEY~~, ~~TRUSTEE~~

LISA BAUGHMAN
Deputy Clerk

Denton
Fairbanks
3 to chambers