UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF WISCONSIN

In re

Case No. 09-21188

DUWAYNE E. KIRCHOFF and
FAITH M. KIRCHOFF,

Chapter 7

Debtors.

UNITED STATES OF AMERICA,
acting by and through the Farm Service Agency,
United States Department of Agriculture,

Plaintiff,

v. Adversary No. 09-2159

DUWAYNE E. KIRCHIFF and
FAITH M. KIRCHOFF,

Defendants.

MEMORANDUM DECISION ON PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT

The plaintiff, the United States of America, acting by and through the Farm Service Agency (FSA), United States Department of Agriculture, filed an adversary proceeding under 11 U.S.C. § 523(a)(6) seeking a determination that obligations owed it by the debtors were excepted from their discharge, as well as a denial of both debtors' discharges under 11 U.S.C. § 727(a)(3). The plaintiff moved for summary judgment on all three counts of its complaint. Although the defendants filed an answer to the complaint, they did not respond to the motion for summary judgment.

This is a core proceeding under 28 U.S.C. §§ 157(b)(2)(I) and (J), and the Court has jurisdiction under 28 U.S.C. § 1334. The following constitutes the Court's findings of facts and

conclusions of law pursuant to Fed. R. Bankr. P. 7052. For the reasons stated below, the plaintiff's motion is granted in part and denied in part.

BACKGROUND

In 1998, the Farm Service Agency financed DuWayne Kirchoff's purchase of approximately 133 head of livestock. Subsequently, 115 head of the collateral livestock, valued at $124,000, went missing and unaccounted for. On May 22, 2000, DuWayne Kirchoff filed a chapter 7 petition in this district, Case No. 00-24786. On August 29, 2000, the plaintiff filed an adversary proceeding pursuant to 11 U.S.C. § 523 seeking the nondischargeability of the debt owed by the defendant for conversion of the livestock. The parties later stipulated to judgment and on April 17, 2001, the Court entered an order excepting the $124,000 obligation from discharge.

In 2004, defendant Faith Kirchoff, formerly known as Faith Thompson, obtained loans from the plaintiff, secured by livestock and feed. Faith Kirchoff subsequently obtained two additional loans from the plaintiff on October 5, 2005. Based upon a September 20, 2005, appraisal, the value of the collateral was $183,450.

Faith Kirchoff married DuWayne Kirchoff in 2005 and both parties signed a security agreement dated September 19, 2005. Pursuant to the security agreement, the debtors granted the plaintiff a security interest in, among other things, all livestock then owned or thereafter acquired, together with all increases, replacements, substitutions, and additions thereto. Furthermore, pursuant to the security agreement, the debtors agreed "not to abandon the collateral or encumber, conceal, remove, sell or otherwise dispose of it or of any interest in the collateral, or permit others to do so, without the prior written consent of the Secured Party."

(Security Agreement entered September 19, 2005, § 3B(6)).

The security agreement signed by the debtors reflected the following livestock: 61 cows, four bred heifers, three open heifers (age 14-15 mos.), seven open heifers (age 12 mos.), five open heifers (age 2-5 mos.), five heifer calves (age 0-2 mos.), and six steers (age 10-12 mos.). The security agreement also reflected that 17 cows were going to be purchased with the loan proceeds. Twenty cows were actually purchased. Therefore, the total livestock securing the loans were 111 head.

An inspection on February 17, 2006, revealed the following livestock: 40 cows, two bred heifers, five heifer calves, and one steer; for a total of 48 animals. Feed was also missing from the farm and the debtors did not turn over proceeds from the sale of feed or account for the missing feed.

In October 2006, the debtors had an auction and sold 24 cows, three open heifers, two heifer calves, and one bull calf, for a total of 30 animals. The proceeds from the auction sale of these animals were turned over to the FSA, and these animals are not part of the claim involving missing livestock. A total of 77 animals have gone missing and the debtors have not responded to the FSA's request for records relating to the missing livestock.

The debtors filed bankruptcy on February 3, 2009, and the Farm Service Agency commenced this adversary proceeding on May 21, 2009. Debtors filed a timely answer to the complaint, stating they could provide justification, excuse and explanation for the loss of livestock and refuting the allegation that their actions were willful and malicious. The answer also stated that the parties were estranged and were not living together when the losses were allegedly incurred, and the culpability of the parties and damages should be adjudicated

separately. While the debtors did respond to the plaintiff's Request to Admit or Deny and Request for Production of Documents, their responses were untimely and unsigned, and no documents were produced. The debtors did not file a response to the plaintiff's motion for summary judgment.

ARGUMENT

The Farm Service Agency argues the nondischargeability judgment entered in 2001 against DuWayne Krichoff should be declared nondischargeable in this case because debts excepted from discharge remain so in subsequent bankruptcies. Additionally, the debt owed by Faith Kirchoff should be excepted from discharge pursuant to section 523(a)(6) because the FSA has been injured by the debtors' willful and malicious conduct; namely the debtors' failure to account for the missing livestock. Finally, FSA argues the debtors should be denied discharges under section 727(a)(3), due to their failure to produce any records that trace, explain or account for the missing livestock and feed.

DISCUSSION

Summary judgment is appropriate where the moving party establishes that there is no genuine issue of material fact and that the party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(c); *Celotex Corp. v. Catrett*, 477 U.S. 317, 323, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). "Material facts" are those facts which "might affect the outcome of the suit," and a dispute about a material fact is "genuine" if a reasonable finder of fact could find in favor the nonmoving party. *See Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). Summary judgment is appropriate where a party has failed to make "a showing sufficient to establish the existence of an element essential to that party's case and on

which the party will bear the burden of proof at trial." *Celotex*, 477 U.S. at 322-23. A party opposing summary judgment may not rest upon the mere allegations or denials of the adverse party's pleading, but must set forth specific facts showing that there is a genuine issue for trial. Fed. R. Civ. P. 56(e); *Heft v. Moore*, 351 F.3d 278, 282-83 (7th Cir. 2003). Any doubt as to the existence of a material fact is to be resolved against the moving party. *Anderson*, 477 U.S. at 255.

In viewing the facts presented on a motion for summary judgment, a court must construe all facts in a light most favorable to the non-moving party and draw all legitimate inferences in favor of that party. *See NLFC, Inc. v. Devcom Mid-Am., Inc.*, 45 F.3d 231, 234 (7th Cir. 1995). A court's role is not to evaluate the weight of the evidence, to judge the credibility of the witnesses, or to determine the truth of the matter, but instead to determine whether there is a genuine issue of triable fact. *See Anderson*, 447 U.S. at 249-50.

Neither of the defendants opposed the plaintiff's motion for summary judgment. This alone is an insufficient basis for a grant of summary judgment, since the plaintiff still must establish the absence of a genuine issue of material fact before it can prevail on a summary judgment motion. Fed. R. Civ. P. 56(e)(2) ("[i]f the opposing party does not ... respond, summary judgment should, *if appropriate*, be entered against that party") (emphasis added); *see Tobey v. Extel/JWP, Inc.*, 985 F.2d 330, 332 (7th Cir. 1993).

Additionally, under Fed. R. Civ. P. 36, the failure to respond constitutes an admission. However, this is not a case in which the plaintiff made requests for admission and the defendants *completely* failed to respond. *Cf.* Fed. R. Civ. P. 36(b); *United States v. Kasuboski*, 834 F.2d 1345, 1350 (7th Cir. 1987) (default admissions under Rule 36 can serve as factual predicate for

summary judgment); *Luick v. Graybar Elec. Co.*, 473 F.2d 1360, 1362 (8th Cir. 1973) (summary judgment may be based on admitted matter). The debtors in this case submitted untimely and unsigned responses to the plaintiff's interrogatories and request for production. In essence, those responses included general statements that no information or records were available, as well as the following:

> An auction sale was held on August 17, 2006 with the approval and knowledge of FSA and USDA, in fact at their urging, said sale being a complete farm auction of farm machinery, equipment, crops and livestock conducted by Schmidt Auction Service ..., proceeds were paid to FSA ....
>
> Some livestock died but we have no records, nor can we provide any further details or information to document this. ...
>
> Records were not maintained, some records in possession of Atty Vicki E. Zick, which records were forwarded to Casper Law Office and reviewed, but other than the auction sale documents, all that was received were copies of documents and correspondence generated by plaintiff and presumably in plaintiff's possession.

(Defendants' Response to First Set of Interrogatories). For purposes of summary judgment, the Court will consider these responses as facts not in dispute.

Count One of the plaintiff's complaint asserts that the April 24, 2001, nondischargeable judgment against DuWayne Kirchoff is excepted from discharge in this case. The debtors have not contested this allegation; they merely observe that DuWayne's nondischargeability judgment is not applicable to Faith. The plaintiff's motion for judgment on Count One is therefore granted and the previous nondischargeable judgment against DuWayne Kirchoff is excepted from DuWayne's discharge in this case.

Count Two of the plaintiff's complaint alleges that the amount owed the FSA by Faith Kirchoff should be excepted from discharge pursuant to 11 U.S.C. § 523(a)(6). A debt "for

willful and malicious injury by the debtor to another entity or to the property of another entity" is nondischargeable. 11 U.S.C. § 523(a)(6). To prevail under this count, a creditor must prove by a preponderance of the evidence that the debtor's conduct was both willful and malicious. *Grogan v. Garner*, 498 U.S. 279, 287, 111 S.Ct. 654, 659, 112 L.Ed.2d 755 (1991). In general, this exception to discharge is limited to debts resulting from "a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury." *Kawaauhau v. Geiger*, 523 U.S. 57, 61, 118 S.Ct. 974, 140 L.Ed.2d 90 (1998).

When a secured creditor seeks to have a debt held nondischargeable on the basis that the debtor converted its collateral, it is still incumbent on the creditor to establish that the requirements of a "willful and malicious injury" dischargeability exception are met. *In re Jones*, 276 B.R. 797, 801 (Bankr. N.D. Ohio 2001). Consequently, "'[d]ebtors who willfully break security agreements are testing the outer bounds of their right to a fresh start, but unless they act with malice by intending or fully expecting to harm the economic interests of the creditor, such a breach of contract does not, in and of itself, preclude a discharge.'" *In re Logue*, 294 B.R. 59, 63 (B.A.P. 8th Cir. 2003) (quoting *In re Long*, 774 F.2d 875, 882 (8th Cir. 1985)).

One court found it was inappropriate to grant summary judgment based only on the debtor's intentional violation of the terms of a security agreement by selling collateral without the secured creditor's consent and retaining the proceeds. *In re Contella*, 166 B.R. 26 (Bankr. W.D. N.Y. 1994). The creditor had not demonstrated unequivocally at the summary judgment stage that the debtor's conduct was also willful and malicious, without proof of a specific intent to injure. The court noted it was possible the debtor may have misunderstood his obligations under the security agreement or he might have acted under a belief that those obligations were

waived, or that any breach would be cured through his timely payment of the loan as it would otherwise have become due. *Id*. at 30; *see also In re Granati*, 270 B.R. 575 (Bankr. E.D. Va. 2001), *aff'd*, 307 B.R. 827 (E.D. Va. 2002), *aff'd*, 63 Fed. Appx. 741 (4th Cir. 2003) (material question of fact, as to whether debtor acted in knowing disregard of factoring company's rights in assigned annuity payments, or in honest belief that assignment was invalid and that she could stop paying factoring company if she became financially incapable of doing so, precluded entry of summary judgment). While the record shows that DuWayne had experience in the cattle business, we have no indication of Faith's knowledge or involvement in the enterprise.

Several courts have found conversion of collateral constitutes a willful and malicious injury under section 523(a)(6). *See In re Cantrell*, 208 B.R. 498 (B.A.P. 10th Cir. 1997) (debtor's obligation to bank with security interest in his cattle could be excepted from discharge, as one for debtor's willful and malicious injury to person or property of another, given evidence that debtor was experienced businessman with knowledge of bank's rights under security agreement, but had nevertheless acted in violation of those rights by selling cattle and not remitting proceeds to bank, or using proceeds to pay prior lienholder, while at the same time concealing sales from bank); *In re Coltrane*, 273 B.R. 478 (Bankr. D. S.C. 2001) (conversion of property subject to a perfected security interest constituted "willful and malicious injury" to property); *In re Bullington*, 167 B.R. 157 (Bankr. W.D. Mo. 1994) (debtor husband's egregious conduct willfully and maliciously caused lessors injury, rendering debt nondischargeable, where debtor sold calves in which creditor had legal rights and offered no explanation of what happened to proceeds of such sale; purported lease was really contract for sale which transferred ownership of calves to debtors subject to security interest retained by sellers, and selling of such collateral by debtor

without first obtaining secured creditor's consent was conversion); *cf. In re Grisham*, 245 B.R. 65 (Bankr. N.D. Tex. 2000) (where debtor-business partners sold cattle subject to bank's security interest within one year of the petition date and without bank's consent, without paying sale proceeds to bank, and without replacing the cattle, debtors transferred the collateral with the intent to hinder, delay, or defraud bank, for discharge denial purposes, with respect to that portion of the sale proceeds that was not used to pay operating expenses or loan interest and whose use remained unaccounted for by debtors).

The case of *In re Thompson*, 315 B.R. 94 (Bankr. W.D. Mo. 2004), *amended in part on other grounds*, 316 B.R. 326 (Bankr. W.D. Mo. 2004), appears to be more factually similar to this case. The *Thompson* court found the debtors willfully and maliciously converted cattle subject to the creditor's security interest, thereby causing him injury. The debtors offered no credible explanation or justification for their loss of the cattle and instead asked the court to believe that 131 cattle, representing more than 25% of their herd, vanished into thin air over a 12-month period. The cattle apparently did not wander onto a neighbor's farm, and the debtors' insistence that they were too busy to ever count the cattle, even though they knew the cattle were disappearing, and that they made no inquiry of their employees or of each other as to the problem throughout the year, was not credible.

On the other hand, various courts have concluded that many debtors' conversions of collateral were not done willfully and maliciously. *See In re Logue*, 294 B.R. 59 (B.A.P. 8th Cir. 2003) (finding that debtor did not act with malice, for nondischargeability purposes, in selling cattle other than in accordance with security agreement, was supported by evidence that debtor sold the cattle in batches at different auctions in order to maximize price and that debtor used the

proceeds as needed to maintain the remaining herd rather than delivering the proceeds to bank); *In re Glatt*, 315 B.R. 511 (Bankr. D. N.D. 2004) (even assuming debtor sold horses securing creditor's claim without turning sales proceeds over to creditor, his alleged conversion of creditor's collateral, in attempt to keep his struggling business afloat, did not rise to level of "malicious" injury, of kind required in order to except his debt to creditor from discharge as one for his "willful and malicious injury"); *In re Crump*, 247 B.R. 1 (Bankr. W.D. Ky. 2000) (debt arising from debtor's deliberate failure to remit proceeds generated from sale of crop in which creditor had security interest not excepted from discharge, as one for debtor's "willful and malicious injury" to property of another, given complete lack of evidence that debtor, by failing to remit sales proceeds and by instead reinvesting them in his farming operation in order to keep it afloat, intended to cause any injury to creditor; debtor's actions, in granting creditor a security interest in crops subsequent to credit transaction and without receiving any new value from creditor, and in undergoing substantial sacrifices himself in attempt to preserve farm, were inconsistent with intent to injure); *cf. In re Grisham*, 245 B.R. 65 (Bankr. N.D. Tex. 2000) (although debtor-business partners converted bank's collateral by selling a substantial number of head of cattle that secured debtors' loan without bank's consent, without paying sale proceeds to bank, and without replacing the cattle, debtors did not willfully and maliciously injure bank, for discharge purposes, with respect to the $269,730 of collateral sale proceeds that they used for loan interest payments and operating expenses consistently with their course of dealing with bank, but they did willfully and maliciously injure bank as to the $515,315.50 in sale proceeds that remained unaccounted for).

At least one court refused to accept the debtor's subjective intent in trying to save the

business as sufficient to overcome the malicious aspect of 11 U.S.C. § 523(a)(6). In *In re Russell*, 262 B.R. 449 (Bankr. N.D. Ind. 2001), an obligation arising from the debtor-farmer's conversion of the creditor's collateral was excepted from discharge as a "willful and malicious injury," even though the farmer used proceeds from the sale of a soybean crop in his farm operation rather than to pay the secured debt. He also used corn that was subject to the creditor's security interest as feed for his small pigs. The debtor found himself in a difficult situation with respect to the corn, which was the only available source of feed for his pigs. The court found that while this difficulty may have excused a temporary or limited misuse of the creditor's collateral, it did not excuse the debtor's conduct over the many weeks it took to dispose of the thousands of bushels of corn harvested that year, especially where the debtor never advised the creditor of his situation or of what he was doing. Nevertheless, the result came after trial and not on a motion for summary judgment, so the court had an opportunity to determine the debtor's knowledge and intent in disregarding the creditor's rights.

Even if the creditor is successful in objecting under section 523(a)(6) to the discharge of its claim for willful and malicious conversion of collateral, the measure of damages is the value of the collateral at the time of conversion rather than the amount owed by the debtor. *In re Modicue*, 926 F.2d 452 (5th Cir. 1991); *In re LeBlanc*, 346 B.R. 706 (Bankr. M.D. La. 2006); *In re Taylor*, 211 B.R. 1006 (Bankr. M.D. Fla. 1997). Evidence is necessary to make such a determination.

Count Three of the plaintiff's complaint alleges the debtors concealed, destroyed, mutilated, falsified, or failed to keep or preserve recorded information including books, documents, records, and papers, from which the plaintiff could trace and identify the livestock,

livestock proceeds, feed or feed proceeds in violation of section 727(a)(3). Under section 727(a)(3), the court shall grant the debtor a discharge unless: "the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case." 11 U.S.C. § 727(a)(3).

A creditor states a prima facie case under section 727(a)(3) by showing that the debtor failed to maintain and preserve adequate records, and that such failure makes it impossible to ascertain the debtor's financial condition and material business transactions. *In re Happel*, 394 B.R. 915, 922 (Bankr. E.D. Wis. 2008). After showing inadequate or nonexistent records, the burden of proof then shifts to the debtor to justify the inadequacy or nonexistence of the records. *Id*. The Seventh Circuit has held that section 727(a)(3) "places an affirmative duty on the debtor to create books and records accurately documenting his business affairs." *In re Scott*, 172 F.3d 959, 969 (7th Cir. 1999) (citing *Matter of Juzwiak*, 89 F.3d 424, 429 (7th Cir. 1996)).

As noted above, while the debtors' answer to the complaint stated they could provide justification, excuse and explanation for the loss of the livestock collateral, their responses to the plaintiff's interrogatories and request for production included numerous general statements that no information or records were available, and records were not maintained. The debtors' relative sophistication and participation in the operation are crucial to whether they should be held accountable for lack of records. It would not be appropriate for this Court to weigh the evidence, to make any credibility determinations or draw inferences unfavorable to the debtors. *See In re French*, 499 F.3d 345 (4th Cir. 2007) (case remanded where bankruptcy court made

inappropriate credibility determinations in assessment of motion for summary judgment, and a genuine issue of material fact existed whether records disclosed by debtor would permit parties to reasonably ascertain his financial condition); *cf. In re Caneva*, 550 F.3d 755 (9th Cir. 2008) (debtor's conclusory statement in affidavit that absence of records is justified was not enough to avoid summary judgment under section 727(a)(3)).

CONCLUSION

For the reasons stated above, this Court grant's the plaintiff's motion for summary judgment with respect to the exception to discharge of DuWayne's loan, previously excepted from discharge in Case No. 00-24786. The motion is denied as to all other counts, and those matters will be scheduled for trial. A separate order for judgment and judgment will be entered accordingly.

February 18, 2010

Margaret Dee McGarity
Chief Judge, U.S. Bankruptcy Court