

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF WISCONSIN

In re:

RICHARD W. WAITE &
MARY ELLEN WAITE,

Debtors.

Case No. 95-28196

Chapter 7

VIRFRAN, INC.
d/b/a DUNN LUMBER,

Plaintiff,

v.

Adversary No. 96-2326

RICHARD W. WAITE &
MARY ELLEN WAITE,

Defendants.

AMENDED MEMORANDUM DECISION

The plaintiff brought this adversary proceeding against the individual chapter 7 debtors under 11 U.S.C. § 523(a)(4) and (6). The plaintiff seeks to recover over \$100,000.00, which is comprised of several component parts and which will be addressed separately. A trial was held on November 18, 1996, after which the court took the matter under advisement. For the reasons stated herein, the court finds in the plaintiff's favor on all issues, and all amounts owed the plaintiff by the debtors are excepted from the discharge of each debtor.

This court has jurisdiction under 28 U.S.C. § 1334(b); this is a core proceeding under 28 U.S.C. § 157(b)(2)(I). This decision constitutes the court's findings of fact and conclusions of law under Fed. R. Bankr. P. 7052.

I. FACTS

The situation involving the plaintiff and the debtors is fairly commonplace. The plaintiff, doing business as Dunn Lumber, sold lumber to the debtors' business. The debtors owned and ran a corporation known as Five Star Realty, Inc., d/b/a Five Star Homes. Five Star assembled and modified modular homes and used the plaintiff's product in modifications to the homes and in construction of garages. Mrs. Waite was president and ran the office, and Mr. Waite was vice president/secretary and managed construction, mainly from job sites. All of Dunn Lumber's product which was sold to Five Star was for the latter's various building projects, and the site where the lumber was to be delivered and used was identified with each purchase.

On February 16, 1995, judgment against the debtors and their corporation was entered in Walworth County Circuit Court for \$91,103.87, plus interest from June 9, 1994, representing Five Star's unpaid invoices to Dunn Lumber. Other matters were yet to be resolved, and on December 15, 1995, the parties stipulated, among other things, that \$91,126.21 remained unpaid on the original judgment, including \$20,000.00 for plaintiff's attorney's fees, and \$15,000.00 would be added as "punitive damages" if the full amount of the judgment was not paid on or before January 15, 1997. (Stipulation and Order, ¶¶ 1, 2, 7, 8; Trial Ex. # 50) Defendants also stipulated "that a court or jury could find a factual basis for such an award." (Stipulation and Order, ¶ 8; Trial Ex. # 50) The parties were not present when the December 15, 1995 stipulation was read into the record, but both attorneys represented that they had authority to agree to the terms of the stipulation. (Transcript of proceedings in Walworth Co.; Trial Ex. # 51) The debtors' attorney also represented that Mrs. Waite had signed the stipulation, but Mr. Waite was unavailable. After that hearing, Mr. Waite never signed the written stipulation, and Mrs. Waite

tore up the original that she signed. At her deposition, she stated her attorney (who does not represent the Waites in the bankruptcy) had authority to settle, but he pressured her and she later had misgivings. Therefore, the only record of the second judgment was the order and the transcript of the attorneys' statements in court regarding the agreement.

The debtors do not contest the amount of the December 15, 1995 judgment as it relates to the \$91,126.21 still owed on the earlier judgment. However, they argue that (1) the judgment for unpaid invoices is discharged, or at least discharged as to Mr. Waite; (2) costs of sale of a boat seized by the sheriff in July 1995 and sold in August 1996 (Trial Ex. #'s 52-59) to enforce the judgment were unreasonable; (3) attorney's fees should be discharged; and (4) the "punitive damages" should be discharged.

II. DISCUSSION

A. Unpaid invoices

The debtors would prefer to not be bound by the agreement as to their liability on the December 15, 1995 judgment. The written agreement is unsigned by the debtors, and Mrs. Waite tore up the copy she signed. She stated in her deposition that she was pressured into giving her attorney authority, but she did so. If she felt she did not, her remedy was to appeal that decision, but once it became final, this court is bound by it.

Section 523(a)(4) of the Bankruptcy Code provides that a debtor is not discharged for a debt for "defalcation while acting in a fiduciary capacity." The plaintiff has the burden of proof by a preponderance of the evidence. *Grogan v. Garner*, 498 U.S. 279 (1991). Exceptions to discharge are construed liberally in favor of the debtor and against the creditor. *Meyer v. Rigdon*,

36 F.3d 1375, 1385 (7th Cir. 1994).

State law determines whether a fiduciary relationship exists, and federal law determines how that relationship, or breach thereof, is treated in a bankruptcy. In Wisconsin, the relationship between a general contractor and a subcontractor is determined pursuant to Wis. Stat. § 779.02(5), which provides, in relevant part, the following:

. . . all moneys paid to any prime contractor . . . by any owner for improvements, constitute a trust fund only in the hands of the prime contractor . . . to the amount of all claims due or to become due or owing from the prime contractor . . . for labor and materials used for the improvements, until all the claims have been paid. . . . The use of any such moneys by any prime contractor . . . for any other purpose until all claims, except those which are the subject of a bona fide dispute . . . is theft by the prime contractor. . . .

§ 779.02(5), Wis. Stats.

An officer responsible for payments to be made by a corporation acting as the prime contractor is personally liable. *Id.* Therefore, references to the debtor or debtors are interchangeable with their corporation, Five Star.

The elements of theft by contractor were interpreted in *Kraemer Bros., Inc. v. Pulaski State Bank*, 138 Wis. 2d 395, 402-03, 406 N.W.2d 379, 383 (1987). That case stated

as long as payments can be traced from the owner to the subcontractor the monies in the hands of the subcontractor are held in trust under the statute for the benefit of the second-tier subcontractors. This interpretation of the statute comports with the practices of the industry. *Typically the prime contractor serves as a conduit for payments from an owner to a subcontractor.*

Id. (emphasis added). *Kraemer* involved sub-subcontractors, but the same principle applies — the prime contractor is the conduit and has no beneficial interest in payments made to him by the owner until all of his subcontractors are paid.

The *Kraemer* court cited *W.H. Major & Sons, Inc. v. Krueger*, 124 Wis. 2d 284, 369

N.W.2d 400 (Ct. App. 1985), which held, on the facts of the case, that the prime contractor was liable for funds that could be traced to the owner but not where there was no evidence that the owner paid the prime contractor before the prime contractor paid the subcontractors. Therefore, for the plaintiff to prevail, it must prove that funds for the improvements passed from the owner to the prime contractor and did not reach the plaintiff/subcontractor.

Wisconsin's theft by contractor statute has been interpreted as recognizing a trust relationship between the prime and subcontractor, the breach of which constitutes a defalcation as that term is used in 11 U.S.C. § 523(a)(4). *Matter of Thomas*, 729 F.2d 502, 505-06 (7th Cir. 1984). A violation under Wis. Stat. § 779.05 is nondischargeable under § 523(a)(4).

This court is mindful of a case decided in the Western District, *In re Koch*, 197 B.R. 654 (Bankr. W.D. Wis. 1996), in which the court held that more than negligent defalcation is necessary for nondischargeability under § 523(a)(4), even though defalcation under Wisconsin law may be attributable solely to negligence. The court cited *Meyer v. Rigdon*, 36 F.3d 1375 (7th Cir. 1994), which involved defalcation under § 523(a)(11). This court is satisfied that willfulness, recklessness, or any other standard in excess of defalcation is not required for a debt to be nondischargeable under § 523(a)(4). However, this case, like *Meyer*, involved debtors that knew the requirements of the law. They were experienced builders, having been in the business many years. They reported to the plaintiff where each purchased would be used, and several jobs were accounted for separately by Dunn Lumber. Without question, the debtors were aware of the custom in the construction industry referred to in *Kraemer*, 138 Wis. 2d at 402-03; 406 N.W.2d at 383. Therefore, any failure to pay subcontractors when the owner paid Five Star would entail

more culpability on the part of the debtor than mere negligence. Thus, the additional element alluded to in *Koch* is present in this case.

The evidence showed that for the jobs for which lumber was purchased from Dunn Lumber, the owners paid the full contract price, and for each job receipts were sufficient to pay all suppliers. (Trial Ex. #'s 2-49). The debtors' cost analyses show that each job garnered a profit, or there would be a profit before Five Star's overhead was added to expenses. Since the suppliers are entitled to payment before the general contractor can be paid its overhead, it is clear that Five Star received all amounts due the plaintiff for each contract, and it is not necessary to prorate Dunn Lumber's claim along with the other suppliers.

Mrs. Waite is clearly included in the category of individuals for which Wis. Stat. § 779.02(5) and 11 U.S.C. § 523(a)(4) were designed to apply: the corporate officer responsible for paying suppliers for improvements to property but who failed to do so even after the corporation was paid by the owner. The amount due for unpaid invoices is nondischargeable as to her.

Nevertheless, the debtor's argue that even if the debt is excepted from Mrs. Waite's discharge, it should not be excepted from Mr. Waite's discharge. Since Mr. Waite worked in the field, not in the office, he was not responsible for which suppliers were paid. Courts have been reluctant to discharge one spouse when both spouses work in the business. *See, e.g., In re Lansford*, 822 F.2d 902, 905 (9th Cir. 1987) (both spouses bore responsibility for false and misleading financial statement); *Matter of Walker*, 726 F.2d 452, 454 (8th Cir. 1984) (sufficient involvement by debtor husband such that he knew or should have known of wife's fraud); *In re Taite*, 76 B.R. 764, 773-74 (Bankr. C.D. Cal. 1987) (spouse not entitled to discharge although

she lacked control of corporate decisions and activities, she had actual knowledge of and participated in business of corporation, and fraud was conducted in ordinary course of corporation's business). Mr. Waite had signature powers on the corporate bank account, and he sometimes wrote checks for materials delivered to the job sites. He was an experienced builder and was well aware of the requirement that suppliers are to be paid when the owner's payment has been received by the contractor. He was an integral part of this business and cannot isolate himself from the financial aspect of what he did every day. Five Star's debt for invoices due the plaintiff is also excepted from Mr. Waite's discharge.

B. Boat expenses

As part of Dunn Lumber's collection proceedings, the Waites transferred a boat to Dunn. The record shows that the boat was sold for \$47,000.00 after the December 15, 1995 judgment was entered, and the debtors should be credited for some amount toward satisfaction of the judgment. The debtors argue that the expenses of sale were too high and should not be deducted in full in arriving at the net amount of the sale, but no evidence was presented as to what a reasonable amount would be. The plaintiff had previously rejected an offer of \$41,000.00, so the court is satisfied that the sale price is reasonable. The boat, or parts of it, were moved several times, and it was stored for over a year, resulting in considerable storage charges. Mr. Dunn testified that the boat was held for so long because the Waites expected to sell some real estate, pay off the judgment, and redeem the boat. This expectation was not refuted, and it is also undisputed that the plaintiff cooperated when the debtors sent potential buyers to see the boat. The debtors presented no evidence that the repairs were unnecessary or that the broker's commission was unreasonable. Therefore, the court finds that the plaintiff's expenses of

\$10,039.10 were reasonable, and the debtors are entitled to a credit of \$36,960.90 on the December 15, 1995 judgment.

C. Attorney's fees

The debtors' objection to their liability for attorney's fees pursuant to the December 15, 1995 judgment is based not on the reasonableness of the fee but on whether that segment of the judgment should be excepted from the discharge, even if the unpaid invoices are excepted. The amount is established by claim preclusion, and the rule in the Seventh Circuit is that attorneys' fees are treated for nondischargeability purposes the same as the underlying liability. *Klingman v. Levinson*, 831 F.2d 1292, 1296-97 (7th Cir. 1987).

D. Punitive damages

The *amount* of what was termed "punitive damages" was established by the December 15, 1995 judgment, and this court is bound by claim preclusion to that amount. *In re Back Bay Restorations, Inc.*, 118 B.R. 166, 169-70 (Bankr. D. Mass. 1990) (bankruptcy courts bound by prior judgments of amount of resulting damages). The plaintiff argues that the punitive damages should be excepted from the discharge under 11 U.S.C. § 523(a)(6) as a willful and malicious injury to the plaintiff's interest in the funds paid by the owners. The debtors agreed "that a court or jury could find a factual basis for such an award," (Trial Ex. # 50), and the type of conduct that would support a punitive damages award would also support a determination of nondischargeability under 11 U.S.C. § 523(a)(6). The debtors believe there was insufficient proof of the willful and malicious nature of their conduct that would cause 11 U.S.C. § 523(a)(6) to apply.

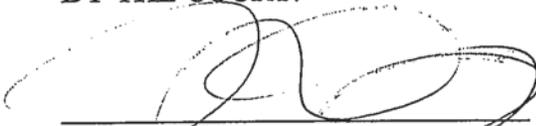
It is not necessary to characterize the debtors' conduct as willful and malicious to find that the punitive damages portion of the December 15, 1995 judgment is also excepted from the discharge of both debtors. As with attorney's fees, punitive damages follow the nondischargeability of the underlying damages, i.e., the Dunn Lumber invoices. *See, e.g., In re Bugna*, 33 F.3d 1054, 1058-59 (9th Cir. 1994) (punitive damages nondischargeable under § 523(a)(4)); *In re Britton*, 950 F.2d 602, 606 (9th Cir. 1991) (punitive damages nondischargeable under § 523(a)(6)); *In re Van Quach*, 187 B.R. 615, 621 (Bankr. N.D. Ill. 1995) (punitive damages nondischargeable under § 523(a)(6)); *In re Pawlinski*, 170 B.R. 380, 392 (Bankr. N.D. Ill. 1994) (punitive damages nondischargeable under § 523(a)(4)). The punitive damages are also excepted from the discharges of both debtors.

III. CONCLUSION

For the reasons stated above, the plaintiff's judgment against the debtors in the Walworth County Circuit Court dated December 15, 1995, is excepted from the discharge of both debtors. The judgment is in the original amount of \$91,126.21 and \$15,000.00 for punitive damages. The debtors shall be credited with payments made since the judgment was entered, including \$36,960.90 for the boat sold by the plaintiffs. An order for judgment will be entered accordingly.

Dated at Milwaukee, Wisconsin, May 12, 1997.

BY THE COURT:



Honorable Margaret Dee McGarity
United States Bankruptcy Judge