In the United States Bankruptcy Court

for the Northern District of Iowa

PAUL DEAN JERDEE MONICA LAURA JERDEE *Debtor(s).*	Bankruptcy No. 99-00176-C Chapter 7
UNION BANK & TRUST COMPANY *Plaintiff(s)* vs. PAUL DEAN JERDEE MONICA LAURA JERDEE *Defendant(s)*	Adversary No. 99-9053-C

ORDER

This matter came on for trial before the undersigned on Plaintiff's Complaint to Determine Dischargeability on March 13, 2000. Plaintiff Union Bank & Trust Company was represented by Attorney Daniel H. Swift. Debtor-Defendants Paul Dean Jerdee and Monica Laura Jerdee were represented by Attorney Timothy G. Goen. The time for filing briefs has now passed and this matter is ready for resolution. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(I).

FINDINGS OF FACT

Debtors Paul Dean and Monica Laura Jerdee borrowed $100,000 from Plaintiff Union Bank & Trust Company (the Bank) in October 1997. Mr. Jerdee used this loan to operate his business as a Snap On Tools dealer. In exchange for the loan, the Bank took a security interest in Debtor's inventory, equipment, and accounts receivable. The Bank perfected this security interest by filing the proper UCC documents with the Secretary of State. By perfecting its security interest, the Bank gained a first lien on the collateral.

Debtors sold some of this collateral (the inventory) back to Snap On Tools Corporation for between $15,000 and $20,000 on December 17, 1998. At that time, Debtors owed nothing to Snap On Tools Corporation because the Bank had paid it off to obtain a first lien on Debtors' inventory, equipment, and accounts receivable. Debtors knew the Bank had a security interest in the inventory when they sold it. Debtors testified that they intended to use the proceeds to cover living expenses.

During this time, Debtors entered into negotiations with the Bank to restructure their debt. Debtors had already begun to sell collateral (the Snap On Tools van) and other property (a 1993 Chevy pickup) prior to renegotiation in order to meet loan payments. The parties had reached an agreement in December 1998 that extended repayment over a period of ten years, however, Debtors did not sign. They were unable to complete the restructuring due to the withdrawal of their cosigners from the deal.

Unable to restructure their debt, Debtors filed for relief under Chapter 7 of the Bankruptcy Code on January 29, 1999.

After filing, Debtors continued to collect accounts receivable from their Snap On Tools business. The Bank had a perfected security interest in these accounts. The Bank discovered that Debtors were making collections post-petition when it investigated a list of accounts receivable Debtors had provided prior to filing bankruptcy. Debtors admit to collecting accounts receivable post-petition. They testified the funds were necessary for living expenses as well as expenses related to Mrs. Jerdee's heart condition and recent surgery.

The Bank argues that Debtors' acts constitute a "willful and malicious injury" within the meaning of 11 U.S.C. § 523(a)(6) and that its claim is not subject to discharge. Debtors counter that the Bank has failed to meet its burden of proof regarding the elements of a nondischargeability claim under § 523 (a)(6).

CONCLUSIONS OF LAW

A discharge in a Chapter 7 bankruptcy discharges a debtor from "all debts that arose before the date of the order for relief." 11 U.S.C. § 727(b). The filing of a voluntary petition constitutes an order for relief under Chapter 7. 11 U.S.C. § 301. Debts incurred by a debtor after the Bankruptcy petition has been filed are not subject to an order of discharge entered in the case. Bush v. Taylor, 912 F.2d 989, 993 (8th Cir. 1990); In re Newmark, 177 B.R. 286, 290 (Bankr. E.D. Mo. 1995).

A discharge order does not affect debts properly excepted from discharge. 11 U.S.C. § 727(b). Exceptions to discharge are listed in 11 U.S.C. § 523, which provides in part:

> (a) A discharge under section 727 ...of this title does not discharge an individual debtor from any debt--
>
> ...
>
> (6) for willful and malicious injury by the debtor to another entity or to the property of another entity.

The analysis of dischargeability under § 523(a)(6) is guided by the principle that exceptions to discharge must be "narrowly construed against the creditor and liberally construed against the debtor." In re Van Horne, 823 F.2d 1285, 1287 (8th Cir. 1987). Because the Bank seeks a finding of nondischargeability under § 523(a)(6), it bears the burden of proving each of the elements of its claim by a preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 291 (1991).

A successful claim under § 523(a)(6) requires proof of an actual intent to cause injury, not merely an intentional act that causes injury. Kawaauhau v. Geiger, 118 S. Ct. 974, 977 (1998). Conversion may be an "injury" under § 523(a)(6) if it is proven to be willful and malicious. In re Wolfson, 56 F.3d 52, 54 (11th Cir. 1995); In re Holtz, 62 B.R. 782, 785 (Bankr. N.D. Iowa 1986). The elements of willfulness and malice must be analyzed separately under § 523(a)(6). In re Long, 774 F.2d 875, 880-81 (8th Cir. 1985).

DISCUSSION

The Bank seeks to except its claims from discharge on the theory that Debtor converted its security interest in inventory and accounts receivable. The Bank argues that these conversions were "willful and malicious" injuries excepted from discharge under 11 U.S.C. § 523(a)(6). The Court will examine each claim in turn, beginning with the conversion of inventory.

CONVERSION OF SNAP ON TOOLS INVENTORY

Although the question of nondischargeability is purely a matter of federal law, the validity and amount of Debtors' obligation is a question of state law. Grogan, 498 U.S. at 282-85. In this case, Iowa law determines whether Debtors committed conversion while federal law determines whether the conversion was "willful and malicious."

Under Iowa law, conversion is defined as "a distinct act of dominion wrongfully exerted over another person's property in denial of or inconsistent with his title or rights therein." Blessing v. Norwest Bank Marion, N.A., 429 N.W.2d 142, 144 (Iowa 1988). A perfected security interest is property within the meaning of this definition. Id.; 89 C.J.S. Trover and Conversion § 15.

Debtors converted the Bank's property under Iowa law when they sold their inventory back to Snap On Tools Corporation. This inventory was subject to the Bank's perfected security interest, yet Debtors sold the collateral and retained all of the proceeds. Their actions were in denial of the Bank's rights in the inventory and their retention of the proceeds was wrongful.

Whether Debtors' conversion created a debt that is nondischargeable in bankruptcy is a separate question requiring further analysis. First, the conversion must have been willful; it must have been committed deliberately and intentionally. In re Madsen, 195 F.3d 988, 989 (8th Cir. 1999). Debtors deliberately and intentionally sold inventory to Snap On Tools Corporation knowing that the Bank had a security interest in the inventory. Debtors readily admitted this at trial. Debtors acted "willfully" within the meaning of § 523(a)(6). Id.

Second, the Bank must prove that Debtors acted maliciously when converting the inventory. Long, 774 F.2d at 880-81. Proof of malice requires proof of a "heightened level of culpability... going beyond recklessness and beyond intentional violation of a security interest." Id. at 881. In order for a conversion to be malicious, it must be "targeted at the creditor," with an actual intent to cause financial harm. In re Scarborough, 171 F.3d 638, 641 (8th Cir. 1999). A mere technical conversion does not meet the requirements for nondischargeability under § 523(a)(6): "Knowledge that legal rights are being violated is insufficient to establish malice, absent some additional aggravated circumstances." Long, 774 F.2d at 881; See In re McClean, Adv. No. 96-1214-C, slip op. at 4 (Bankr. N.D. Iowa Aug. 5, 1997).

Malice may be inferred after considering all of the circumstances surrounding a conversion. In re Jansma, Adv. No. 95-5047-XS, slip op. at 17 (Bankr. N.D. Iowa July 30, 1996). Acts of concealment support the inference. Id. at 15. The purposes served by the conversion also bear on whether it was malicious. Id. at 17. The likelihood that financial harm will result from the conversion is relevant. Long, 774 F.2d 875 at 881. An inference of malice may turn on the credibility of witnesses. Jansma, Adv. No. 95-5047-XS, slip op. at 17.

Not surprisingly, the parties differ in their interpretation of the intent behind Debtors' conduct. The Bank believes that Debtors harbored some ill will toward it and that they converted inventory intending to cause it harm. Debtors deny this, arguing that they converted inventory because they

needed money to live. Given this conflict, the maliciousness of Debtors' acts must be determined with reference to the circumstances surrounding the conversion. Id.

No circumstances exist that support an inference of malice. Debtors' efforts to restructure just prior to filing bankruptcy suggest that the conversion was not malicious. Their efforts reveal an intent to maintain a cooperative relationship with the Bank, not an intent to harm it. While the failure of restructuring talks may have given Debtors a motive to injure the Bank by selling its collateral, it is more reasonable to conclude that the parties' failed restructuring efforts forced Debtors to continue selling property in order to meet living and medical expenses.

Prior to restructuring talks, Debtors were already liquidating property in order to meet their expenses. Debtors sold their Snap On Tools van and traded another truck for an older model in order to pay down the Bank's note. After the failed restructuring, Debtors continued this course of conduct by selling inventory back to Snap On Tools. While they stopped paying on the note, Debtors continued to meet payments on other obligations owed to the Bank, including their home mortgage. Debtors' course of dealing before and after the conversion supports the conclusion that the conversion of inventory was aimed at meeting living expenses, not at harming the Bank.

The Bank has failed to establish by a preponderance of the evidence that Debtors' conversion of their Snap On Tools inventory was malicious. Debtors were strapped for cash prior to restructuring talks with the Bank and were selling property to meet loan payments. Had the restructuring succeeded, the proceeds from the conversion might have been used to pay off the Bank's note. Financial harm to the Bank was not so certain as to support an inference of malice. Debtors did not conceal their acts or otherwise indicate that they intended to harm the Bank by their conversion of inventory. Because the Bank has failed to prove that Debtors acted maliciously, its claim is not excepted from discharge under 11 U.S.C. § 523(a)(6).

CONVERSION OF ACCOUNTS RECEIVABLE

The Bank pursues an identical theory of willful and malicious injury with regard to Debtors' post-petition collection of accounts receivable. The Bank alleges that this collection was a conversion, that it was willful and malicious, and that the resultant debt should be excepted from discharge under § 523(a)(6). This theory cannot be sustained because debts arising from Debtors' post-petition conduct are not affected by their bankruptcy discharge.

A bankruptcy discharge relieves a debtor from liability for only those debts that arose before the order for relief. 11 U.S.C. § 727(b). Any debt arising after the order for relief is not discharged. Id. In a Chapter 7 case, the order for relief coincides with the filing of the voluntary petition. 11 U.S.C. § 301. At the moment Debtors' petition was filed, all of their existing debts became subject to discharge under § 727(a) because they arose before the order for relief. Any debts that came into existence after the moment of filing arose after the order for relief and cannot be discharged. 11 U.S.C. §§ 301, 727 (b). Debtors' collection of accounts receivable occurred after they filed their Chapter 7 petition. Any debt arising from this conduct arose after the order for relief and is not discharged. See Id.; Bush, 912 F.2d at 993; Newmark, 177 B.R. at 290.

SUMMARY AND CONCLUSION

In order for its claim to be excepted from discharge under § 523(a)(6), the Bank must prove that Debtors converted its collateral with the intention of causing it financial harm. Proof that Debtors

acted intentionally coupled with proof that the Bank suffered harm is not enough absent additional circumstances that support an inference of malice on the part of Debtors.

No circumstances exist that support an inference of malice in this case. Debtors did convert inventory in which the Bank held a security interest, but their purpose was to cover living expenses and pay other bills, not to harm the Bank. Debtors were in the process of liquidating property when the conversion occurred. They did not conceal the conversion. Debtors' efforts to restructure their debt mitigate against an inference of malice. The Bank has not proved by a preponderance of the evidence that the conversion was malicious and its claim cannot be excepted from discharge under 11 U.S.C. § 523(a)(6).

Debts arising after the voluntary filing of a Chapter 7 bankruptcy petition are not subject to a discharge order granted in the case. Pursuant to 11 U.S.C. § 727(b), any debt arising from Debtors' post-petition collection of accounts receivable is not discharged.

WHEREFORE, the Bank has failed to prove by a preponderance of the evidence that Debtors maliciously converted inventory in which it held a security interest.

FURTHER, the Bank's claim regarding Debtors' conversion of inventory is discharged under 11 U.S.C. § 727(a).

FURTHER, any debt incurred by Debtors after the filing of their bankruptcy petition is not subject to the discharge order in this case.

SO ORDERED this 10th day of April, 2000.

Paul J. Kilburg
Chief Bankruptcy Judge