IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TENNESSEE

In re WILLIAM E. RUSSELL d/b/a B & B CARPET and LETHA RUSSELL, Debtors.	No. 95-31767 Chapter 7
RUSSOX CONTRACTING, INC., TERRY W. FOX and ANGELA D. FOX, Plaintiffs, *vs*. WILLIAM E. RUSSELL d/b/a B & B CARPET and LETHA RUSSELL, Defendants.	Adv. Pro. No. 95-3117

M E M O R A N D U M

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MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY JUDGE

In this adversary proceeding, Russox Contracting, Inc. ("Russox") and Terry and Angela Fox (the "Foxes") seek a judgment against the debtors arising out of certain alleged fraudulent acts and a determination that the judgment is nondischargeable pursuant to 11 U.S.C. § 523(a)(4). For the reasons set forth below, the court finds for the debtors and this proceeding will be dismissed. The following sets forth the court's findings of fact and conclusions of law pursuant to Fed. R. Bankr. P. 7052, based on the evidence presented at the trial of this action on June 26, 1996. This is a core proceeding. *See* 28 U.S.C. § 157(b)(2)(I).

I.

William E. Russell and Terry W. Fox were lifelong friends. Their friendship began as childhood neighbors and continued into their adulthood and after each married. They and their wives socialized together and Mr. Russell, a building contractor,

constructed the Foxes' home and a dress shop for Terry Fox's wife, Angela Fox.

In May 1990, the Russells and Foxes decided to go into business together for the purpose of constructing speculative residential houses. They formed the corporation, Russox, with each of the four owning 25% of the stock and serving as officers. Because it was contemplated that the day to day affairs of the business would be conducted by William Russell and Angela Fox, Mr. Russell was designated as president and Mrs. Fox as secretary, with Mrs. Russell and Mr. Fox respectively serving as vice-president and treasurer. For operating capital, Russox obtained a $250,000.00 line of credit from Home Federal Bank of Tennessee, secured by the personal guaranties of the Russells and Foxes and by prospective liens on the speculative houses Russox would be constructing.

From the beginning, Russox was operated informally out of the parties' homes, with its office initially being at the Russells' residence and later at the Foxes' residence. William Russell and Angela Fox were the only paid employees. Mr. Russell was responsible for the construction end of the business and Mrs. Fox handled the company's paperwork, including control of the corporate checking account, although both had singular authority to write checks on the corporation's behalf. Often,

Mr. Russell would obtain four or five blank checks from Mrs. Fox to pay subcontractors and suppliers on a construction site and later would call or drop by Mrs. Fox's home to tell her to whom and for what amounts the checks had been written so that information could be recorded. The actual bookkeeping tasks for Russox, including posting the checks, reconciling the bank statements, and preparing tax returns was handled by Jimmie Fowler, an employee of Mr. Fox at his automobile dealership.

For the most part, Terry Fox and Letha Russell were uninvolved in Russox's day-to-day operations. Mr. Fox was busy with the operation of his automobile dealership and Mrs. Russell worked at B & B Carpet, a carpet store owned by the debtors and the brother of Mrs. Russell. B & B Carpet otherwise had no connection with Russox or the Foxes, although the flooring for the "spec" houses constructed by Russox was purchased from B & B Carpet.

In early 1991, the Russells began the construction of a new store for B & B Carpet. Upon experiencing cost overruns, William Russell requested a loan in the amount of $9,000.00 from Russox, to be repaid when Mr. Russell obtained a construction loan from Gulf America on behalf of B & B Carpet. The parties disagree as to whether this request was made to both Angela and Terry Fox, as the debtors contend, or just Angela Fox, as

asserted by the Foxes, and whether the loan was to be repaid within a week to ten days. Nevertheless, it is undisputed that it was agreed that William Russell could borrow $9,000.00 from Russox and on April 2, 1991, Mr. Russell drew Russox check no. 463 in this amount payable to himself.

Within the next two months, William Russell wrote three other Russox checks for use by B & B Carpet. On April 12, 1991, Mr. Russell drew check no. 510 payable to himself for $18,000.00. On May 1, 1991, Mr. Russell drew and cashed check no. 611 made payable to Home Federal Bank in the amount of $11,500.00. Thereafter, on June 11, 1991, Mr. Russell drew check no. 535 payable to himself for $7,500.00.

There is a dispute between the Russells and the Foxes as to whether these last three checks were authorized by the Foxes. The Russells maintain that these checks, like the check of April 2, 1991, were loans from Russox which had been preapproved by the Foxes. Mr. Russell testified that in fact, when he had requested the second loan, Angela Fox responded that she had also borrowed from the corporation. The Foxes deny that they authorized any loans to the Russells other than the initial sum of $9,000.00 and both testified that the other three checks were written by William Russell without their prior knowledge or consent. Mrs. Fox stated that she learned of these checks

several days to a week after each had been written when William Russell telephoned her or came by her house to relay the check information for recording, but that she did not inform her husband of the unauthorized withdrawals because she expected Mr. Russell to repay these amounts.

By late summer of 1991, Russox had sold the three houses it had under construction and paid all of the net proceeds from those sales to Home Federal Bank, yet over $100,000.00 remained owing on the line of credit. The Home Federal Bank employee responsible for the Russox account became concerned about the lack of security for the debt and telephoned Terry Fox, inquiring as to when the debt would be repaid and seeking additional collateral. Mr. Fox testified that he was unaware of Russox's financial situation until this call and that upon questioning his wife about the line of credit balance, learned of the other three withdrawals by William Russell.

The sequence of events which occurred within the next few months thereafter was unclear from the testimony of the parties. At some point, the debtors obtained the contemplated construction loan for B & B Carpet from Gulf America, but proceeds from the loan were insufficient to pay all the debts of B & B Carpet. The Russells made attempts to obtain a second mortgage on the B & B Carpet store to repay the debt owed to

Russox, but were unable to do so. The Russells did manage to pay $10,000.00 on the Russox line of credit debt directly to Home Federal Bank. In the fall of 1991, William Russell and the Foxes met with Home Federal Bank to discuss repayment of the line of credit balance since by that time Russox was no longer in business. On November 22, 1991, the Foxes provided Home Federal Bank a second mortgage on their home to further secure Russox's debt and in January 1992, the Foxes and the Russells began making monthly interest payments to Home Federal Bank, which payments continued at least through 1993.

Some time later, the Russells sold B & B Carpet, hoping to receive enough from the sale to pay off not only the store's debts but also the debt to Russox. Proceeds from the sale, however, were insufficient to pay even B & B Carpet's debts in full. On July 18, 1995, the Russells filed for chapter 7 relief, seeking a discharge of their obligations to Russox and Home Federal Bank, along with their other personal debts, and the balance of B & B Carpet's indebtedness. Thereafter, the Foxes sold their home and on February 20, 1996, paid in full Russox's debt to Home Federal Bank which by that time totaled $109,519.35 due to accumulated interest.

On November 21, 1995, the plaintiffs, Russox and the Foxes, filed the present adversary proceeding, asserting that because

of the allegedly unauthorized withdrawals described above "the Russells are guilty of fraud or defalcation while in a fiduciary capacity as more fully set forth in 11 U.S.C. Section 523(a)(4) of the United States Bankruptcy Code; the Russells are guilty of fraud and/or embezzlement in a personal capacity as more fully set forth in 11 U.S.C. Section 523(a)(4) of the United States Bankruptcy Code; [and] the Defendant, William E. Russell, is also guilty of embezzlement as more fully set forth in 11 U.S.C. Section 523(a)(4) of the United States Bankruptcy Code." Plaintiffs contend that at the time of the transactions at issue, William Russell was acting in a fiduciary capacity as president of Russox. The plaintiffs do not allege what gives rise to their allegation that Letha Russell was a fiduciary, other than the fact that she was an officer of the corporation and that otherwise she knew of the transactions. Both Russox and the Foxes assert that they are owed the sum of $36,000.00[1] by the Russells due to the debtors' alleged fraud or embezzlement and that this indebtedness is nondischargeable pursuant to 11 U.S.C. § 523(a)(4) which excepts from discharge any debt for "fraud or defalcation while acting in a fiduciary

[1]Presumably, the $36,000.00 amount is derived from the withdrawals of $9,000.00, $18,000.00, $11,500.00 and $7,500.00 (total of $46,000.00) on April 2 and 12, May 1, and June 11, 1991, respectively, less the $10,000.00 payment by the Russells to Home Federal Bank in 1991.

capacity, embezzlement, or larceny."

The debtors deny that they are guilty of fraud, defalcation, or embezzlement or that they were fiduciaries to the Foxes individually, although they do not deny that they were fiduciaries to Russox. Furthermore, the debtors contend that the plaintiffs' asserted claims are barred by applicable Tennessee statutes of limitations.

II.

The court will address initially the statute of limitations issue raised by the debtors. There is little question that state statutes of limitation have relevance in bankruptcy. It is axiomatic that before a debt can be found nondischargeable, there must first be a debt. *See Mills v. Gergely (In re Gergely)*, 186 B.R. 951, 956 (9th Cir. BAP 1995). Any determination of nondischargeability is a two-step process, requiring first the establishment of a debt and thereafter, if a debt is found, a determination of its discharge. *See Resolution Trust Corp. v. McKendry (In re McKendry)*, 40 F.3d 331, 337 (10th Cir. 1994), *rehearing denied* (1994); *Illinois Dept. of Public Aid v. Wilder (In re Wilder)*, 178 B.R. 174, 176 (Bankr. E.D. Mo. 1995); and *U.S. v. Taylor (In re Taylor)*, 137 B.R. 925, 928 (Bankr. S.D. Ind. 1991). A creditor can not get

beyond the first step if its underlying claim fails. *See In re McKendry*, 40 F.3d at 337; and *In re Taylor*, 137 B.R. at 928.

The Bankruptcy Code defines "debt" as a "liability on a claim," *see* 11 U.S.C. § 101(12); and the United States Supreme Court has indicated that the meanings of "debt" and "claim" are coextensive. *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 558, 110 S. Ct. 2126, 2130 (1990). "Claim" is defined in the Code as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured ...." 11 U.S.C. § 101(5)(A). "Right to payment" has been interpreted by the U.S. Supreme Court to mean "nothing more nor less than an enforceable obligation." *Davenport,* 495 U.S. at 559, 110 S. Ct. at 2131. *See also Long v. Donahue (In re Long),* 148 B.R. 904, 908 (Bankr. W.D. Mo. 1992); and *In re Wilder*, 178 B.R. at 176. Accordingly, in order for a claim, and hence a debt, to exist, there must be a right to payment, *i.e.,* an enforceable obligation.

A creditor has no greater rights in bankruptcy than it does prior to the petition being filed. *See In re Gergely*, 186 B.R. at 956. Whether an enforceable obligation exists is governed by the state statute of limitations. *See In re McKendry*, 40 F.3d

at 337. *See also Grogan v. Garner*, 498 U.S. 279, 283, 111 S. Ct. 654, 657 (1991)("The validity of a creditor's claim is determined by rules of state law."). If suit is not brought within the time period allowed under state law, there is no enforceable obligation and the creditor does not have a claim to pursue in a dischargeability proceeding. *See In re McKendry*, 40 F.3d at 337*; In re Gergely*, 186 B.R. at 960; *Bane v. LeRoux (In re Curran)*, 183 B.R. 9, 11 (Bankr. D. Mass. 1995); *In re Wilder*, 178 B.R. at 177; *In re Taylor*, 137 B.R. at 928; *Braun v. McKay (In re McKay),* 110 B.R. 764, 767 (Bankr. W.D. Pa. 1990); *Mortgage Guaranty Insurance Corp. v. Pascucci (In re Pascucci),* 90 B.R. 438 (Bankr. C.D. Cal. 1988); and *General Electric Credit Corp. v. Dunn (In re Dunn)*, 50 B.R. 664, 665-66 (Bankr. W.D.N.Y. 1985). Therefore, the appropriate inquiry is whether the Tennessee statutes of limitations for the claims asserted against the debtors by the plaintiffs — fraud or defalcation in a fiduciary or personal capacity and embezzlement — ran before this bankruptcy case was filed on July 18, 1995. If so, the plaintiffs do not have enforceable obligations against the debtors and hence no claims. Without a claim, a suit with respect to the dischargeability thereof is a useless exercise. *See In re Gergely*, 186 B.R. at 956.

The debtors contend the applicable statutes of limitations governing the plaintiffs' asserted claims are TENN. CODE ANN. §§ 48-18-601, 48-18-304 and 28-3-105, which respectively provide as follows:

> Any action alleging breach of fiduciary duties by directors or officers, including alleged violations of the standards established in § 48-18-301, § 48-18-302 or § 48-18-403, must be brought within one (1) year from the date of such breach or violation; provided, that in the event the alleged breach or violation is not discovered nor reasonably should have been discovered within the one-year period, the period of limitation shall be one (1) year from the date such was discovered or reasonably should have been discovered. In no event shall any such action be brought more than three (3) years after the date on which the breach or violation occurred, except where there is fraudulent concealment on the part of the defendant, in which case the action shall be commenced within one (1) year after the alleged breach or violation is, or should have been, discovered.

TENN. CODE ANN. 48-18-601.

> (a) A director who votes for or assents to a distribution made in violation of § 48-16-401 or the charter is personally liable to the corporation for the amount of the distribution that exceeds what could have been distributed without violating such section or charter if it is established that the director did not perform such director's duties in compliance with § 48-18-301. In any proceeding commenced under this section, a director has all of the defenses ordinarily available to a director.
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> (b) A director held liable under subsection (a) for an unlawful distribution is entitled to contribution from:
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> (1) Every other director who could be held liable under subsection (a) for the unlawful distribution; and
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> (2) Each shareholder for the amount the

> shareholder accepted knowing the distribution was made in violation of § 48-16-401 or the charter.
>
> (c) A proceeding under this section is barred unless it is commenced within two (2) years after the date on which the effect of the distribution was measured under § 48-16-401.

TENN. CODE ANN. § 48-18-304.

> The following actions shall be commenced within three (3) years from the accruing of the cause of action:
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> (1) Actions for injuries to personal or real property;
> (2) Actions for the detention or conversion of personal property;
> (3) Civil actions based upon the alleged violation of any federal or state statute creating monetary liability for personal services rendered, or liquidated damages or other recovery therefor, when no other time of limitation is fixed by the statute creating such liability.

TENN. CODE ANN. § 28-3-105.

The court agrees that TENN. CODE ANN. § 48-18-601 is the applicable statute of limitations for any claims which the plaintiffs may have against the Russells for breach of fiduciary duty by an officer or director. Furthermore, the court concludes that this limitations period expired before this bankruptcy case was filed on July 18, 1995. As quoted above, TENN. CODE ANN. § 48-18-601 provides that an action for breach of fiduciary duty by an officer or director must be brought within one year from the date of such breach or violation unless the alleged breach or violation was not discovered or reasonably

discoverable within the one-year period, in which case the period of limitations is one year from the time it was discovered or reasonably should have been discovered. The statute further provides that in no event shall any such action be brought more than three years after the date on which the breach or violation occurred except that in the case of fraudulent concealment, an action may be brought within one year after the alleged violation was discovered or should have been discovered.

The breaches or violations of which the plaintiffs complain are the three allegedly unauthorized checks totaling $37,000.00 written by William Russell out of Russox's corporate account on April 12, May 1 and June 11, 1991. The debtors' bankruptcy case was commenced on July 18, 1995, more than four years after all of these dates and thus, outside the one-year statute of limitations of TENN. CODE. ANN. § 48-18-601. The exception for fraudulent concealment does not aid the plaintiffs because the evidence clearly establishes that they knew of these alleged violations substantially more than one year prior to the debtors' bankruptcy filing. Angela Fox testified that she learned of the withdrawals within "several days or a week" after they were made and Terry Fox testified his wife advised him in June or July of 1991 of the withdrawals after he received a

telephone call from Home Federal Bank expressing concern regarding the balance and unsecured nature of Russox's line of credit. Furthermore, Russox's bank statements and canceled checks were sent each month during this time to Angela Fox by Home Federal Bank. The May 1991 bank statement listed the April withdrawals by William Russell, the check of May 1 drawn by William Russell was included in the June 1991 bank statement, and the July 1991 statement revealed the June withdrawal by William Russell.

To the extent the withdrawals in question constituted unlawful distributions by a director, any claim therefore would be foreclosed by TENN. CODE ANN. § 48-18-304, which as quoted above provides that an action for unlawful distributions is barred unless commenced within two years after the date on which the effect of the distribution was measured under TENN. CODE ANN. § 48-16-401,[2] *i.e.*, when the funds were withdrawn from the corporation

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[2]In this regard, TENN. CODE ANN. § 48-16-401(e) provides in pertinent part that:

> Except as provided in subsection (g), the effect of a distribution under subsection (c) is measured:
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> ....
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> (2) In the case of any other distribution of indebtedness or distribution through the incurrence of indebtedness, as of the date the indebtedness is distributed or incurred. In a case in which the

(continued...)

by Mr. Russell. This two-year period had long expired when the debtors filed their bankruptcy petition.

With respect to the plaintiffs' asserted claim for fraud or embezzlement, the debtors contend that any such claim is a tort action for injury to property governed by the three-year statute of limitations of TENN. CODE ANN. § 28-3-105 quoted above. The plaintiffs maintain that there is no statute of limitations for fraud in Tennessee and that therefore their claim is still viable. Although plaintiffs are correct that there is no statute of limitations for fraud *per se*, the Tennessee Supreme Court has concluded that actions for common law fraud are governed by the three-year injury to property statute of limitations found in TENN. CODE ANN. § 28-3-105. *See Vance v. Schulder*, 547 S.W.2d 927, 930 (Tenn. 1977). *See also Ockerman v. May Zima & Company*, 27 F.3d 1151, 1155 (6th Cir. 1994)(recognizing *Vance* holding that Tennessee's three-year statute of limitations, TENN. CODE ANN. § 28-3-105, applied to common law fraud actions); *Mackey v. Judy's Foods, Inc.*, 654

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[2](...continued)
incurrence of indebtedness is the granting of a mortgage, security interest, lien, or other encumbrance of the corporation's assets, the indebtedness shall be deemed to be incurred on the date of the execution and delivery of the security instrument granting such mortgage, security interest, lien, or other encumbrance; ....

F.Supp. 1465, 1481 (M.D. Tenn. 1987), *affirmed*, 867 F.2d 325 (6th Cir. 1989)("Tennessee sets a three (3) year limitation period on most of plaintiffs' torts claims, such as fraud."). Because this three-year period expired before the debtors filed their bankruptcy case in 1995, the plaintiffs have no claim for fraud or embezzlement which can be pursued in this bankruptcy case.

III.

Notwithstanding the foregoing, the court has considered the evidence presented in this case to determine whether the factual elements of a debt nondischargeable under 11 U.S.C. § 523(a)(4) have been established. As stated above, § 523(a)(4) of the Bankruptcy Code excepts from discharge any debt "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." The plaintiffs have alleged in their complaint, as amended, that not only are the debtors guilty of fraud or defalcation while in a fiduciary capacity, but that they are also guilty of fraud or embezzlement in a personal capacity.

In order to sustain a cause of action for fraud or defalcation under 11 U.S.C. § 523(a)(4), a plaintiff must establish that the debtor committed the fraud or defalcation while acting in a fiduciary capacity. *See, e.g., Barristers*

Abstract Corp. v. Caulfield (In re Caulfield), 192 B.R. 808, 818 (Bankr. E.D.N.Y. 1996). *See also Capitol Indemnity Corp. v. Interstate Agency, Inc. (In re Interstate Agency, Inc.)*, 760 F.2d 121, 124 (6th Cir. 1985) (in order to establish nondischargeability under § 17(a)(4) of the Bankruptcy Act of 1898, the predecessor to § 523(a)(4), it must be established that the debtor was acting in a fiduciary capacity). A claim for embezzlement or larceny, however, does not require a fiduciary relationship with the debtor. *See In re Caulfield*, 192 B.R. at 818. Accordingly, any allegations against the debtors for fraud in a personal capacity are not actionable under 523(a)(4), although a charge of embezzlement in a personal capacity does fall within this provision.

As a result, the appropriate inquiry under § 523(a)(4) in this case is whether the debtors have committed fraud or defalcation while in a fiduciary capacity or embezzlement in any capacity. Defalcation is defined as encompassing embezzlement, the appropriation of trust funds held in any fiduciary capacity and the failure to properly account for such funds. *See In re Interstate Agency, Inc.*, 760 F.2d at 125. *See also Advance-United Expressways, Inc. v. Wines (In re Wines),* 112 B.R. 44 (Bankr. S.D. Fla. 1990). Embezzlement is the fraudulent appropriation of property by a person to whom such property has

been entrusted or into whose hands it has lawfully come. *See Gribble v. Carlton (In re Carlton),* 26 B.R. 202, 205 (Bankr. M.D. Tenn. 1982). *See also In re Caulfield*, 192 B.R. at 818; and *OnBank & Trust Co. v. Siddell (In re Siddell)*, 191 B.R. 544, 552 (Bankr. N.D.N.Y. 1996). To prove embezzlement, the objecting creditor must show that the debtor misappropriated funds for his own purpose and that he did so with fraudulent intent or deceit. *Id*.

Generally, a corporate officer is a "fiduciary," within the meaning of § 523(a)(4), with regard to the proper treatment of corporate assets over which the corporate officer has control. *See Mozeika v. Townsley (In re Townsley)*, 195 B.R. 54, 63 (Bankr. E.D. Tex. 1996); *Hayes v. Cummins (In re Cummins)*, 166 B.R. 338, 354 (Bankr. W.D. Ark. 1994); and *In re Wines*, 112 B.R. at 46. *Cf., Kapila v. Talmo (In re Talmo)*, 175 B.R. 775, 778 (Bankr. S.D. Fla. 1994). Under Tennessee law, corporate directors and officers occupy a fiduciary relationship to the corporation. *See, e.g., Johns v. Caldwell*, 601 S.W.2d 37, 41 (Tenn. App. 1980), *cert. denied*, (Tenn. 1980). Accordingly, as officers of Russox, the Russells were fiduciaries to Russox.

The plaintiffs contend that the debtors breached their fiduciary duty to Russox by withdrawing Russox funds without

authorization. They observe that no meetings of the board of directors were held to approve these disbursements and that the debtors never executed any promissory notes payable to Russox acknowledging the withdrawn funds. The debtors maintain that notwithstanding the absence of formal board approval and the failure to record these transactions by way of promissory notes, the withdrawals were in fact proper loans approved by the Foxes prior to their occurrence.

The Russells note that all Russox business was conducted informally and verbally by the parties rather than at formal board meetings and that no minutes were ever made approving any of Russox's business transactions, either in advance or afterwards. Furthermore, the debtors assert that Angela Fox was loaning or advancing Russox funds to herself without formal corporate meetings or prior consultation with the Russells. According to the debtors, there was an unwritten, implied understanding between the parties that both Angela Fox and William Russell were authorized to write checks without formal approval. The debtors point out that until their bankruptcy case was filed, there was no animosity between the parties and no allegations that the withdrawals in question were in any way illegal or unauthorized. The debtors argue that the plaintiffs have made these charges because of their disapproval of the

debtors' bankruptcy filing and the resulting discharge of their obligations.

The evidence adduced at trial supports the debtors' position since it did not establish that the debtors either misappropriated or failed to properly account for any of Russox's assets. To the contrary, it was evident that both the debtors and the Foxes had a well-established pattern of making personal loans to themselves with the other's tacit approval. The books and records of Russox introduced at trial reveal that even though Russox never made a profit during the short time it was in business from May 1990 through June 1991, both William Russell and Angela Fox withdrew substantial sums of money other than salary from the corporation. The cash disbursements journal for Russox reflects that in 1990, William Russell received sums totaling $19,070.95 from Russox and Angela Fox received $20,830.00. In 1991, checks totaling $49,500.00 were written to William Russell or on his behalf, including the four disputed withdrawals, and $16,500.00 in checks were written to Angela Fox. In all, William Russell received sums totaling $68,570.95 from Russox and Angela Fox received $37,330.60.

Angela Fox testified that all of the checks to her were for salary, but Russox's tax returns and Mrs. Fox's wage statements do not support this testimony. According to Russox's 1990 tax

return which was prepared by Mr. Fox's employee, no wages, salaries or compensation were paid by the corporation in 1990, and the 1991 return lists total wages of only $14,000.00, with $7,000.00 of the amount presumably for William Russell and $7,000.00 for Angela Fox as set forth in their wage statements from Russox for the year.

Terry Fox testified that he knew that his wife had borrowed various monies from Russox which he believed amounted to $9,300.00.[3] However, all of the checks written to William Russell and Angela Fox in 1990 totaling $19,070.95 and $20,830.00, respectively, are referenced on Russox's 1990 tax return as "loans to shareholders." In addition, it appears that all of the checks to Angela Fox in 1991, other than $7,000.00 in salary, were also loans. Russox's 1991 tax return lists $42,000.00 in shareholder loans for that year, an amount which appears to represent all checks written to William Russell and Angela Fox in 1991 less $14,000.00 for salaries and the $10,000.00 repaid by William Russell some time in 1991.

Thus, according to the corporation's records and the

[3]Mr. Fox testified that he repaid the monies borrowed from Russox by his wife. However, no documentation was provided as to any such repayment other than payment in 1996 of the entire Russox debt when the Foxes' residence was sold, and Russox's 1991 tax return does not indicate any repayment of shareholder loans other than the $10,000.00 by the Russells.

parties' personal income tax returns introduced at trial, William Russell actually borrowed $51,570.95 from Russox (the total of $68,570.95 in checks written to Mr. Russell less the repayment of $10,000.00 and $7,000.00 in salary) and Angela Fox borrowed $30,330.60 (the total of $37,330.60 in checks written to Mrs. Fox less $7,000.00 in salary). There was no evidence that any of these loans were evidenced by promissory notes or formally approved by the board of directors. When Angela Fox was questioned on cross-examination as to whether she had obtained approval from the Russells before she wrote the various checks to herself, she responded that she had the authority to write these checks just like Mr. Russell had the authority. It was clear to the court that both the debtors and the Foxes treated the corporation's bank account as their own personal account from which both couples were free to dip into at any time with the optimistic expectation that they would either be repaid at a future date or that the loans would be offset by anticipated profits. This practice, although quite possibly a major contributor to Russox's collapse, did not constitute defalcation, fraud or embezzlement since it obviously occurred with the tacit agreement of all of the shareholders of the corporation.

Furthermore, for both fraud and embezzlement, there must be

a misappropriation with fraudulent intent. *See Memorial Hospital v. Sarama (In re Sarama)*, 192 B.R. 922 (Bankr. N.D. Ill. 1996). There was no evidence whatsoever in this case of any fraudulent intent. Regardless of whether the Foxes had prior knowledge of the withdrawals by William Russell, it is undisputed that the debtors did not seek to hide the disbursements or falsify them in any way to keep knowledge of them from the Foxes. To the contrary, it was from Mr. Russell that Angela Fox learned of the withdrawals. *See Rentrak Corp. v. Cady (In re Cady)*, 195 B.R. 960 (Bankr. S.D. Ga. 1996)(fraudulent intent which is a prerequisite to a finding of embezzlement under § 523(a)(4) may be negated by the fact that the debtor used such funds openly, without attempting to conceal and had reasonable grounds to believe that he had the right to such use).

In addition, the Foxes did not deny that they did not consider the withdrawals by William Russell to be fraudulent or embezzlements at the time they occurred. Neither criminal charges were filed nor civil actions instituted by the plaintiffs. Not even any demand letters were sent and there was not, in the words of Mr. Russell, “harsh talk.” The Foxes continued to do business with the debtors and the relationship between the parties undisputably remained cordial until the

Russells filed their bankruptcy petition. The Foxes continued to recommend William Russell as a builder and Mr. Russell was the contractor on a house built for Mr. Fox's brother some time after Russox ceased operations. During 1992 and 1993 when interest payments were being made by both couples, Angela Fox went by B & B Carpet each month to pick up the Russells' interest check for mailing and often attempted to sell clothing to Letha Russell, Mrs. Fox apparently having a clothing business as a sideline. Their contacts were always friendly and there was nothing to indicate that the Foxes believed they had been defrauded by the debtors.

The Foxes allege that in addition to being fiduciaries to the corporation, the debtors were also fiduciaries to the Foxes individually and that therefore, they have a personal claim against the debtors for the alleged fraud arising out of that relationship. The basis for this fiduciary capacity was never fully explained and the court is uncertain as to whether the plaintiffs' contend that this fiduciary relationship arose because the parties were stockholders in the same corporation, co-guarantors on the obligation to Home Federal Bank, or that in effect they were engaged in a joint venture. Regardless of the basis for the assertion, the law is clear that the Russells were not fiduciaries to the Foxes as envisioned by 11 U.S.C. §

523(a)(4). The term "fiduciary capacity," as defined by federal law, applies only to technical trusts, express trusts, or statutorily imposed trusts and not to relationships resulting in equitable trusts. *See, e.g., In re Siddell*, 191 B.R. at 551. In Tennessee any claims for breach of fiduciary duty by an officer or director of a corporation belong to the corporation, which in this case is Russox, and the Foxes as shareholders would only be entitled to assert such a claim derivatively in the event the corporation was unwilling to pursue it. *See Lewis on behalf of Citizens Saving Bank & Trust Co. v. Boyd,* 838 S.W.2d 215 (Tenn. App. 1992). Because Russox herein is pursuing the claim against the debtors, the Foxes have no basis to assert a claim for breach of fiduciary duty.

IV.

Based on the foregoing, the court concludes that the plaintiffs have failed to establish either the existence of a claim which is not barred by the applicable Tennessee statutes of limitations or the required elements of nondischargeability under 11 U.S.C. § 523(a)(4). An order will be entered contemporaneously with the filing of this memorandum opinion dismissing this action.

FILED: October 31, 1996

BY THE COURT

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MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY JUDGE