UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

CASEY ZALUSKY | CASE NO. 02-61641

Debtor | Chapter 7

AUTO FINANCE CORPORATION

Plaintiff

vs. | ADV. PRO. NO. 02-80145

CASEY ZALUSKY

Defendant

APPEARANCES:

SMYK, SMYK & FAHRENZ, LLP
Attorneys for Plaintiff
111-115 Court Street
Binghamton, NY 13901

RICHARD E. FAHRENZ, ESQ.
Of Counsel

ALEXANDER W. LUCKANICK, ESQ.
Attorney for Debtor/Defendant
134 Front Street
Binghamton, NY 13905

THOMAS P. HUGHES, ESQ.
Trial Counsel for Debtor/Defendant
23 Oxford Road
New Hartford, New York 13413

Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

Presently under consideration by the Court is the complaint filed by Auto Finance

Corporation ("AFC") on June 20, 2002.[1] AFC seeks a determination of nondischargeability of a debt owed by Casey Zalusky ("Debtor") pursuant to §§ 523(a)(2)(A) and 523(a)(4) of the Bankruptcy Code, 11 U.S.C. §§ 101-1330 ("Code").[2] AFC also requests a judgment in the amount of $98,130.62. Issue was initially joined on July 25, 2002, with the filing of an answer by the Debtor. In his answer the Debtor raised the affirmative defense that the summons and complaint had not been timely filed and served on him.[3]

A trial was conducted in Utica, New York, on October 20, 2003, and continued to November 6, 2003. The Court heard testimony from the Debtor, as well as from Lisa Macy ("Macy"), Branch Manager of AFC's Syracuse, New York office. At the close of AFC's proof, Debtor's counsel made a motion for judgment as a matter of law pursuant to Fed.R.Civ.P. 52(c), incorporated by reference in Fed.R.Bankr.P. 7052, asserting that AFC had failed to meet its burden of proof. The Court reserved on the motion and following testimony by the Debtor, the Court agreed to take the matter under submission. In lieu of closing arguments, the Court

---

[1] The deadline for filing a dischargeability complaint pursuant to Code § 523(c) was June 21, 2002.

[2] AFC's complaint did not specify the subsections of Code § 523(a) under which it was seeking relief. However, at the conclusion of the trial AFC orally moved the Court pursuant to Rule 7015 of the Federal Rules of Bankruptcy Procedure ("Fed.R.Bankr.P."), which incorporates Rule 15(b) of the Federal Rules of Civil Procedure ("Fed.R.Civ.P."), to conform the pleadings to the proof elicited at trial, which the Court granted over the objection of Debtor's counsel.

[3] On December 9, 2002, AFC filed a motion to dismiss Debtor's first affirmative defense and requested that the Court reissue the summons. On March 4, 2003, the Court signed an Order granting the motion of AFC to dismiss Debtor's first affirmative defense, concluding that the Debtor had received ample notice of the adversary proceeding, as evidenced by the filing of an answer. The summons was reissued nevertheless on May 27, 2003, and it, along with the complaint, was served on the U.S. Trustee and Debtor's counsel, as well as the Debtor. Issue was again joined by the filing of an answer by the Debtor on June 18, 2003.

afforded the parties an opportunity to file memoranda of law. The matter was submitted for decision on December 31, 2003.

JURISDICTIONAL STATEMENT

The Court has core jurisdiction over the parties and subject matter of this adversary proceeding pursuant to 28 U.S.C. §§ 1334(b) and 157(a), (b)(1) and (b)(2)(I).

FACTS

The Debtor filed a voluntary petition ("Petition") pursuant to chapter 7 of the Code on March 20, 2002. The Debtor listed AFC as an unsecured creditor with a claim of $98,130.62, identified by the Debtor as being based on purchases of vehicles by the Debtor "on floor plan" on October 14, 2000. AFC filed a proof of claim on June 14, 2002, in the amount of $126,298.86. Debtor testified that he operated a used car dealership in Binghamton, New York, under the name of Orest Auto Sales. It was his testimony that his relationship with AFC began in 1996. According to the initial agreement he had with AFC, dated December 11, 1996, he was given a $50,000 line of credit secured by "all equipment of any kind or nature and all Vehicles, vehicle parts, and other inventory now owned or hereafter acquired, including, without imitation, the Purchase Money Inventory as hereinafter defined, and all additions, accessions, accessories, replacements and proceeds thereof etc." Promissory Note and Security Agreement at §§ 1.4 and 3.0 *in* AFC's Exhibit 1 ("Agreement"). Debtor later applied for an increase in his line of credit on or about March 17, 1999, which, according to the testimony of Macy, was granted in the amount of $75,000. *See* AFC's Exhibit 2. Macy also testified that the line of credit was again increased on or about January 31, 2000, to $100,000. *See* AFC's Exhibit 3.

According to Macy, AFC provides financing to used car dealers for the wholesale purchase of vehicles for resale. After the purchase of a used automobile, title is delivered to AFC. Generally, AFC holds the title to any vehicle purchased by a dealer using money AFC advanced. Upon receipt of payment from the dealer following a vehicle's subsequent sale, AFC releases the title to the dealer for delivery to the retail purchaser. However, dealers such as the Debtor who had established a good working relationship with AFC were given the privilege of having title "loaned out" to them for 48 hours despite the fact that AFC had not been reimbursed for its advance. This allows the dealer to sell the vehicle, often receiving a higher price than it would have without the privilege, without having the delay of obtaining the title at a time subsequent to the sale. Macy testified that in exchange for the loan out of the titles the dealer provides AFC with blank checks for each vehicle, signed and made payable to AFC. If the vehicle is sold, the dealer is to notify AFC of the sale so that AFC can "drop the check," i.e., fill in the amount of the check in order to be reimbursed for its advance on that particular vehicle. If the vehicle is not sold within the 48 hour window, the dealer is required to return the title to AFC. A dealer has 30 days from any advance ("curtailment date") in which to sell a vehicle financed by AFC. *See* Agreement at §§ 1.5 and 1.15. AFC has the discretion of extending the curtailment date, provided that the dealer pays AFC interest, a floor plan fee and a minimum of 10% of the outstanding advance relative to each vehicle purchased. *See id.* at § 2.4.

Under the Agreement, AFC holds a blanket lien on any vehicle that is floor planned with it. According to Macy, between December 1996 and October 2000 Debtor had floor planned approximately 174 vehicles with AFC. The Agreement provides that

> [u]pon the sale of any item of Purchase Money Inventory, Dealer shall hold the amount received from the disposition of inventory in Trust for the benefit of AFC and Dealer shall pay to AFC, in accordance with Section 2.3, an amount equal to the unpaid balance of the Obligation relating to such Purchase Money Inventory.

Id. at § 4.0.

Macy testified that on Wednesday, October 25, 2000, Debtor requested the titles on seven vehicles he had previously purchased using monies advanced by AFC and left seven blank checks to be completed by AFC once the Debtor notified it of the ultimate resale price of the vehicles.[4] According to Macy, an auction occurred on October 27, 2000, at the Manheim Auto Auction ("Manheim") in Manheim, Pennsylvania. When she had not received a phone call from the Debtor informing her of the vehicles that had been sold at the auction, for which he had been given titles, Macy telephoned Manheim and learned that five of the seven had been sold, three on October 27, 2000, and at least one at an earlier auction. Macy testified that she subsequently learned that two others were retail sales.

On Wednesday, November 1, 2000, Debtor faxed a letter indicating that his bank account was "in disarrayed [*sic*]" and requested that the checks he had left with AFC on October 25, 2000, not be cashed. *See* AFC's Exhibit 5. He further indicated that "[t]he cars that I have with AFC were sold and I will work around to pay for them." *Id.*

Macy testified that on November 9, 2000, she visited the Debtor's place of business and visually inspected the vehicles on the lot for repossession. It was her testimony that she spoke

---

[4] The Debtor testified that he requested the titles from someone other than Macy in AFC's office at the TriState Auto Auction in Cicero, New York. It was also his testimony that when he requested the titles on October 25, 2000, he had made no representations concerning whether the vehicles had previously been sold or whether he intended to sell all of them at the Manheim auction on October 27, 2000.

with the Debtor and he agreed to pay AFC $1,500. She also testified that he had told her that he had used the proceeds from the sale of the vehicles in the stock market for margin calls.

He later stopped payment on the $1,500 check. She testified that ultimately she did take possession of two of the vehicles on the Debtor's lot, including a Toyota pickup and a 1994 Honda Accord. According to Macy, AFC sold the Toyota pickup truck and ultimately returned the Honda Accord to the Debtor after he had provided proof that he had sold it. Macy testified that the proceeds from the two vehicles were applied to the principal owed by the Debtor.

On or about November 10, 2000, Debtor was sent a "Legal Notice" by AFC as to his delinquency. *See* AFC's Exhibit 7. Identified in the notice were eight vehicles with payoffs totaling $88,121.80 due. By letter, dated November 13, 2000, AFC further notified the Debtor

> that you have sold numerous vehicles out of Trust without paying or accounting to AFC for the proceeds or other disposition. The foregoing constitutes a violation of your security agreement with AFC. If the full amount of $88,597.97 for the out of Trust sales is not paid within 10 days from the date of this letter, AFC will take legal action to secure full payment.

AFC's Exhibit 6.

According to Macy, AFC had no problems with the Debtor prior to October 2000. Up until October 2000, he had been current on his account and, as noted above, had earned the privilege of operating on a "title loan basis."

Debtor testified that he had one business checking account, which he used in connection with the purchase and sale of vehicles. It was his testimony that at times he had to use other sources of money, including "bridge loans" from his family and the use of credit cards, if the proceeds from the sale of vehicles were insufficient to pay AFC. All such monies were deposited into the business account and, in addition to paying AFC, were used to pay off the loans to family members and to pay down advances made on his credit card accounts.

Debtor testified that at the time he had taken the titles from AFC on October 25, 2000, he intended to pay AFC by means of the blank checks he had left with them. He explained that some of the vehicles were sold for a loss and he had been unable to obtain a "bridge loan" to cover all the checks. According to the Debtor, when he faxed the letter of November 1, 2000, to AFC he had hoped to be able to work something out with them. He acknowledged that he continued to buy and sell automobiles after October 2000 in the hopes of making a profit in order to be able to pay off the debt to AFC. He attributed some of his difficulties to the downturn in the economy beginning in 2000,[5] explaining that there had been a sudden drop in automobile sales and at some of the auctions there were no bids on the cars he had taken to Manheim. Furthermore, he explained that the storage costs increased in direct proportion with the time a car remained unsold at an auction site. Accordingly, there were times when he elected to take a loss on a vehicle when it had remained unsold for several weeks.

DISCUSSION

Underlying any analysis of the Court pursuant to Code § 523(a) is a recognition that exceptions to discharge of a debt are to be "strictly construed against the creditor and liberally in favor of the honest but unfortunate debtor." *In re Kurtz*, 213 B.R. 253, 258 (Bankr. N.D.N.Y.

---

[5] According to the Debtor's Statement of Financial Affairs, he earned no income in 2001 or 2002 from employment or the operation of a business.

1997). The burden rests on AFC to establish by a preponderance of the evidence that the debt should not be discharged. *See Grogan v. Garner*, 498 U.S. 279, 286-91 (1991).

Code § 523(a)(2)(A) provides an exception to the dischargeability of a debt which arose as a result of a debtor's false pretenses, false representation or actual fraud. AFC must establish (1) that the Debtor made the representation; (2) that he knew it was false; (3) that he made it with the intention and purpose of deceiving AFC; (4) that AFC justifiably relied on the representation; and (5) that AFC sustained a loss as a result of its reliance on the representation. *See In re Fanelli*, 263 B.R. 50, 59-60 (Bankr. N.D.N.Y. 2001).

At the trial, AFC focused on the representation made by the Debtor in obtaining the titles to certain vehicles on October 25, 2000. According to Macy's testimony, the Debtor represented to AFC that he intended to sell the vehicles at the Manheim auction on October 27, 2000, when, in fact, at least one of the vehicles had already been sold. Debtor testified that on October 25, 2000, he simply requested the titles without any indication whether or not any of the vehicles had already been sold.

Whatever the representation made by the Debtor to a representative of AFC on October 25, 2000, is of no import to the Court's analysis because the debt to AFC was already in existence on October 25, 2000, and did not arise as a result of his being given the titles to the vehicles. AFC was in possession of the titles to the vehicles because the Debtor had previously purchased them using the line of credit he had received from AFC. The debt to AFC arose at the time the Debtor accessed the line of credit to pay for the purchase of the vehicles for resale. There was no testimony of any alleged misrepresentations made by the Debtor at the time he obtained the advances under the line of credit with AFC to initially purchase those particular vehicles. Accordingly, the Court must deny AFC's request insofar as it is based on Code § 523(a)(2)(A).

AFC also requests relief based on Code § 523(a)(4). In order to succeed pursuant to Code § 523(a)(4), AFC must establish that the debt arose as a result of the Debtor's "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. § 523(a)(4)

Whether or not the Debtor was acting in a fiduciary capacity for dischargeability purposes requires that the Debtor be a trustee either under an express or technical trust, which existed prior to the act creating the debt. *See Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934). A technical trust, which is one imposed by law and may arise either by statute or common law, is inapplicable to the matter herein. Therefore, the Court will focus on whether an express trust was created under the terms of the Agreement.

"An express trust 'requires a declaration of trust and intent to create a trust relationship with respect to a clearly defined res.'" *In re Delisle*, 281 B.R. 457, 466 (Bankr. D. Mass. 2002), quoting *In re Bologna*, 206 B.R. 628, 632 (Bankr. D. Mass. 1997). In this case, the Agreement provides that the Debtor is to hold any proceeds he received from the sale of vehicles "in Trust" for the benefit of AFC. *See* Agreement at § 4. This language, however, is not sufficient for purposes of Code § 523(a)(4) to create a fiduciary relationship between the Debtor and AFC. *See In re Nobel*, 179 B.R. 313, 315 (Bankr. M.D. Fla. 1995); *In re Tester*, 62 B.R. 486, 491 (Bankr. W.D. Va. 1986); *In re Mullins*, 64 B.R. 287, 289 (Bankr. W.D. Va. 1982), *aff'd sub nom. First Am. Nat'l Bank-Eastern v. Jim Lee Mullins, t/a Jim Mullins Motor, Inc.*, Civ. Action No. 86-0170-B (W.D. Va. Feb. 24, 1987), *aff'd*, 848 F.2d 184 (4^{th} Cir. 1988); *see also In re Gallaudet*, 46 B.R. 918, 925 (Bankr. D. Vt. 1985) (noting that "[t]he fact that a commercial agreement contains the word 'trust' does not make the agreement a trust agreement nor does it create a fiduciary relationship"). In *Gallaudet*, the agreement required that the debtor hold the sale proceeds "in trust," but there was no requirement that the debtor segregate the proceeds from the sale of floor-planned vehicles and deposit them into a separate account for the benefit of the creditor. *Id.; cf. In re Rebhan,* 45 B.R. 609, 613 (Bankr. S.D. Fla. 1985), *subsequently aff'd sub nom. Chrysler Credit Corp. v. Rebhan,* 842 F.2d 1257 (11th Cir. 1988) (distinguishing cases granting discharge for failure to remit sales proceeds of financed vehicles where the underlying security agreement did not require the segregation of the proceeds). In *Rebhan* the bankruptcy court found that the agreement between the creditor and the automobile dealership expressly required that the debtor hold the sale proceeds in trust and keep them separate under a formal expressed trust and, accordingly, the debtor was acting in a fiduciary capacity with respect to the proceeds. *See Rehban*, 45 B.R. at 613.

In the matter *sub judice*, there is no provision in the Agreement requiring that the Debtor segregate the proceeds he received from the sale of vehicles subject to AFC's security interest. Indeed, he testified that all proceeds were deposited into a single business account. The Court concludes that the Debtor was not acting in a fiduciary capacity in connection with the proceeds he received from the sale of vehicles despite the statement in the Agreement that the proceeds from the sale of vehicle inventory were to be held "in Trust" by the Debtor.

Accordingly, the Court must examine whether the debt to AFC arose as a result of the Debtor's embezzlement or larceny. The Court had occasion to analyze this issue in *In re Siddell*, 191 B.R. 544 (Bankr. N.D.N.Y. 1996), which states in pertinent party:

> "Embezzlement has been defined as the 'fraudulent appropriation of property by a person to whom such property has been entrusted or into whose hands it has lawfully come." Larceny is to be distinguished from embezzlement in that larceny involves the "*wrongful* taking or carrying away of the property of another with intent to convert such property to his use without the consent of the owner." Thus, larceny differs from embezzlement only in that the original taking was unlawful. To prove embezzlement or larceny, [the creditor] must demonstrate that the Debtors used the

> [] proceeds for their own benefit and did so with fraudulent intent.

Id. at 552 (emphasis supplied) (citations omitted); *see also In re Blanton*, 149 B.R. 393, 394 (Bankr. E.D. Va. 1992) (noting that "'[e]ven where a case might imply some form of trust by virtue of a debtor holding funds for another, the debtor's subsequent appropriation of the funds will not amount to an embezzlement absent proof of the debtor's fraudulent intent'" (quoting *In re Myers*, 52 B.R. 901, 905 (Bankr. E.D. Va. 1985))).

Based on the facts presented, it is clear on its face that the elements of larceny cannot be met because the Debtor was in lawful possession of the proceeds from the sale of the vehicles. The only issue is whether he committed embezzlement by failing to turnover the proceeds to AFC. Thus, the Court must focus on whether the Debtor's appropriation of the monies was done with fraudulent intent. This requires the Court to examine the totality of circumstances and the conduct of the Debtor. *Siddell*, 191 B.R. at 553.

It is clear from the evidence that, up until October 2000, the Debtor and AFC had an excellent working relationship. AFC had increased the Debtor's line of credit from $50,000 in December 1996 to $100,000 in January 2000, a period of approximately three years. Macy testified that approximately 174 vehicles had been sold by the Debtor using AFC's financing prior to October 2000 without any problems. Indeed, the relationship was such that the Debtor had been granted the privilege of operating on a "title loan basis," which allowed him access to the titles prior to the sale of the vehicles. On October 25, 2000, when the Debtor requested and was given the titles to the vehicles by AFC, he left blank checks made payable to AFC and signed by the Debtor. On November 1, 2000, the Debtor wrote to AFC asking that it not "drop the checks" because his account was in disarray. *See* AFC's Exhibit 5. While he later authorized that a check be written for $1,500, he soon recognized that he was without sufficient funds from the sale of the vehicles to cover it and was forced to stop payment on the check.

Debtor testified that he had attempted to obtain a short term bridge loan which would have allowed him to pay AFC. According to the Debtor, not only was he unable to obtain a loan, he also encountered a situation where there was a sudden drop in the purchase of used vehicles and, in some instances, he was forced to sell some of them at a loss in order to minimize the cost of storing the vehicles at the auction facilities. For approximately seventeen months thereafter, he continued in the used car business with the hope of being able to make a sufficient profit to pay AFC. He finally was forced to file for bankruptcy relief in March of 2002. There is nothing in the evidence before the Court to support a finding that the Debtor's failure to pay AFC for the vehicles was done with fraudulent intent. Accordingly, the Court finds that for purposes of Code § 523(a)(4) the Debtor did not commit embezzlement.

Based on the foregoing, it is hereby

ORDERED that the Debtor's motion for judgment as a matter of law pursuant to Fed.R.Civ.P. 52(c), incorporated by reference in Fed.R.Bankr.P. 7052, is granted and AFC's complaint is dismissed in its entirety.

Dated at Utica, New York

this 1st day of April 2004

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge