NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	Chapter 7
JOSEPH C. ROSSITTO,	Case No. 02-38036 (CGM)
Debtor.	
CHARLES VALOIS and SIDEHITCHER, LLC,	Adv. Proc. No. 03-7114
Plaintiffs	
- against -	
JOSEPH C. ROSSITTO,	
Defendant.	

MEMORANDUM DECISION AFTER TRIAL

APPEARANCES:

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CECELIA G. MORRIS
UNITED STATES BANKRUPTCY JUDGE

On January 10, 2005, the Court conducted a bench trial on an objection to the dischargeability of a debt pursuant to 11 U.S.C. § 523(a)(4). Under this section of the

Bankruptcy Code, a debt is not dischargeable if it was incurred as the result of "fraud or defalcation while acting in a fiduciary capacity." As explained more fully below, Plaintiff failed to introduce evidence sufficient to justify a finding of non-dischargeability.

In order for a debt to be non-dischargeable due to a defalcation, a debtor's act must have been an intentional wrongdoing or breach of fiduciary duty. This litigation is the result of a failed joint venture between the parties. Although the Debtor owed Plaintiffs a fiduciary duty, the Debtor's acts did not precipitate the business failure – the project simply proved unworkable. In the course of the adversary proceeding, both individual litigants demonstrated economic and emotional injury from the failed endeavor. Section 523(a) does not, and cannot, serve as a remedy for a creditor's unfortunate investment where, as here, there is no evidence that the Debtor wrongfully intended to profit from his transactions with the creditor and no evidence that he did profit from them. At times, the Debtor failed to keep careful records, and there was a pervasive, mutual lack of communication between the Debtor and Plaintiff Charles Valois, but these acts do not constitute fraud or defalcation.

Jurisdiction

This Court has subject matter jurisdiction pursuant to 28 U.S.C. § 1334(a), 28 U.S.C. § 157(a) and the Standing Order of Reference signed by Acting Chief Judge Robert J. Ward dated July 10, 1984. A determination as to the dischargeability of a debt is a "core proceeding" under 28 U.S.C. § 157(b)(2)(I).

Background Facts

Debtor/defendant, Joseph C. Rossitto ("Debtor"), filed this Chapter 7 case on December 27, 2002. On April 4, 2003 Charles Valois, on behalf of himself and

Sidehitcher, LLC ("Sidehitcher"), the limited liability company jointly owned by Valois and the Debtor, commenced this adversary proceeding objecting to the dischargeability of debt in the asserted amount of $148,236.[1] Debtor answered the complaint on May 6, 2003 by a general denial and asserted no affirmative defenses.

Familiarity with this Court's October 20, 2004 "Memorandum Decision Denying Motions for Summary Judgment and Limiting Issues at Trial" (ECF Docket No. 30; the "Summary Judgment Decision") is assumed, and the findings and defined terms in the Summary Judgment Decision are incorporated by reference.

Sidehitcher is a New York limited liability company. Sidehitcher was organized to develop, manufacture and market the "Sidehitcher," a machine designed to serve as an attachment to existing lawn mowers. The principals of Sidehitcher are Valois and the Debtor. Valois holds the patent to the Sidehitcher. The Debtor was also the sole shareholder and president of a business known as Iona Industries, Inc. ("Iona"). Iona, an established business, was used as a subcontractor for Sidehitcher and provided many of the services needed to build the Sidehitcher units. Valois claims that he invested approximately $21,000 into the Sidehitcher business. Valois claims that the Debtor did not invest any of his own funds, but that Iona paid approximately $16,000 in Sidehitcher bills. Sidehitcher built one prototype unit and received a single order for 75 units. That sale of 75 units resulted in receipt of $165,000. Valois alleges that the per-unit cost to produce Sidehitcher machines was less than $1,400. Valois' adversary proceeding is based on the belief that approximately $60,000 in proceeds should have been left over after the total cost of producing the 76 Sidehitcher units.

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[1] Following trial, Plaintiffs now assert that the amount is $95,230. Plaintiffs' Proposed Conclusions of Law, ¶5.

In the Summary Judgment Decision, the Court limited the scope of trial to examining whether evidence of defalcation could be determined from four types of checks identified by the Plaintiffs. Plaintiffs' Trial Exhibit 1 contains check detail for the year 2001, the period at issue.[2] Plaintiffs have asserted that "[t]he evidence of [Debtor's] perfidy is contained herein in this check detail." Plaintiffs' Motion for Summary Judgment, ¶19 (ECF Docket No. 24).

- Type 1: Four checks (Nos. 97, 1129, 1146 and 1162) that were issued to Iona for a total of $66,136. Plaintiffs reason that these payments are improper and too high based upon the total cost of manufacturing 76 Sidehitcher units.
- Type 2: Plaintiffs assert that: "The most outrageous of the unauthorized expenses is check number 1161 to Key Bank [for $29,094.13] which indicates it is a Keybank Loan. Sidehitcher never had a loan with Keybank. Sidehitcher was never authorized to enter into any loan agreement with Keybank." Plaintiffs' Motion for Summary Judgment, ¶22. Plaintiffs' Trial Exhibit 2 is a commercial loan statement from Keybank to Iona that shows payment of $29,094.13 to Keybank on November 12, 2001 by the Sidehitcher check. Plaintiffs conclude that the Keybank loan "had absolutely nothing to do with Sidehitcher and is the most glaring example of [Debtor's] misappropriation and fraud ...." Plaintiffs' Motion for Summary Judgment, ¶22.
- Type 3: Plaintiffs withdrew their allegations as to the Type 3 checks at trial, and no evidence was presented. Transcript of January 10, 2005 Trial (hereafter, "Tr."), p. 167.
- Type 4: Check No. 1135 in the amount of $10,000, paid to the Debtor. Plaintiffs contend that this check was improperly issued to the Debtor because the Debtor has no documents to establish a loan made to the business, and there was never any discussion between them about repayment. Plaintiffs have characterized the payment as Debtor's "unilateral decision," and accuses the Debtor of "clearly . . . using the Sidehitcher account to keep his company, [Iona], afloat." *See* Plaintiffs' Motion for Summary Judgment, ¶ 21.

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[2] It appears that Sidehitcher was formed in February 2001 and had ceased to conduct business by December 2001.

Thus, the sole issues to be determined at trial were to be (1) the reason why the checks discussed above were issued, and (2) whether Debtor's issuance of any of those checks constitutes "fraud or defalcation while acting in a fiduciary capacity." The Court ruled that all remaining issues would be irrelevant, including: (a) the amounts invested by the Debtor and Valois (except to the extent that it may justify the "Type 4" check), (b) the meaning of Debtor's "admission" on Valois's answering machine that Iona owed money to Sidehitcher, (c) comparison of the financial statements and corrected financial statements (which would show nothing more than the amount of money Sidehitcher owed to the Debtor), (d) the reason why the Sidehitcher machine could not be successfully developed (Plaintiff has never claimed that the Sidehitcher product's failure is connected with Debtor's alleged defalcation), and (e) whether or not Valois "stole all Sidehitcher production machinery" and sold those components for his own benefit.

DISCUSSION [3]

A plaintiff carries the burden of proving by a preponderance of the evidence that a debt is excepted from discharge under Section 523(a). *Grogan v. Garner*, 498 U.S. 279, 286 (1991).

Section 523(a)(4) excepts from discharge any debt which is found to have been incurred "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." Only "fraud or defalcation while acting in a fiduciary capacity" is alleged in this adversary proceeding. Courts in this circuit have held that defalcation "requires at least some element of wrongdoing on the part of the debtor/fiduciary". *Zohlman v. Zoldan (In re Zoldan)*, 221 B.R. 79, 88 (Bankr. S.D.N.Y. 1988). "[M]ere negligence,

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[3] The following are the Court's findings of facts and conclusions of law pursuant to Fed. R. Bankr. P. 7052.

without some element of intentional wrongdoing, breach of fiduciary duty or other identifiable misconduct, does not constitute 'defalcation' within the meaning of section 523(a)(4)." *Samuels v. Ellenbogen (In re Ellenbogen)*, 218 B.R. 709, 714 (Bankr. S.D.N.Y. 1998) (finding no cases in which a court clearly denied a debtor's discharge for a defalcation for truly innocent or merely negligent conduct). Certainly, the meaning of "defalcation" must be defined in the context of the "well-established interpretational rule that exceptions from discharge are to be strictly construed so as to give maximum effect to the policy of the bankruptcy code to provide debtors with a 'fresh start'." *Kawaauhau v. Geiger (In re Geiger)*, 113 F.3d 848, 853 (8th Cir. 1997), *aff'd*, 523 U.S. 57 (1998).

> Section 523(a) of the Bankruptcy Code sets forth those circumstances under which dischargeability may be denied in respect of particular debts. Certain subsections of Section 523(a) deny dischargeability of debts arising from conduct of the debtor which was inherently wrongful, illicit or morally reprehensible. Subsections (2), (4) and (6) . . . are examples, and it is a prerequisite of each that the claim be predicated upon some demonstrably wrongful, illegal or morally reprehensible conduct by the debtor.

In re Hyman, 320 B.R. 493, 501 (Bankr. S.D.N.Y. 2005) (Hardin, Jr., J.) (emphasis added). "The purpose of Section 523 was to remove from the debtor's capacity the ability to discharge certain debts arising from practices Congress deemed so pernicious that bankruptcy should not insulate the debtor from their payment. For our purposes, defalcation is 'willful neglect,' essentially a standard of recklessness or at least gross negligence." *Zohlman v. Zoldan*, 226 B.R. 767, 777-778 (S.D.N.Y. 1998) (Conner, J.).

Because the burden of proof remains with the Plaintiffs, the Court focuses on the checks identified by the Plaintiffs as improper transfers caused by the Debtor, rather than attempt to account for all funds received by Sidehitcher. In this case, the Debtor made a reasonable attempt to explain the disposition of the Sidehitcher proceeds, and the Court

found his testimony to be credible. To hold that some money is not accounted for does not, by itself, meet the definition of a defalcation. *See, e.g., Zohlman v. Zoldan*, 226 B.R. at 777 (rejecting creditor's urging "essentially to hold that any partner guilty of sloppy record keeping is a fiduciary who has committed defalcation for purposes of § 523(a)(4)"). *See also Elmwood Dry Dock & Repair v. H&A Trading Co.*, 1997 WL 781298, at *21 (E.D. La. Dec. 16, 1997) (refusing to find defalcation in debtor's failure to keep proper accounts for operating expenses; although court concluded debtor "was a sloppy accountant and that there were unexplained discrepancies in the expense reports," evidence was insufficient to show these discrepancies were product of debtor's willful neglect or recklessness).

The Type 1 Checks

Plaintiffs offer the Type 1 Checks as evidence that Iona had been over-reimbursed based upon the total cost of manufacturing 76 Sidehitcher units. Although the Debtor contends the unit cost of each Sidehitcher was $1,685.68, Plaintiffs argue that the unit cost was less than $1,400. As the Plaintiffs now agree that the unit cost was as much as $1,400,[4] or a total cost of $106,400, there is nothing patently improper in the fact that Iona received checks totaling $66,136 in reimbursement for its costs.

Underlying the Plaintiffs' accusations concerning the Type 1 checks is the allegation that the Debtor paid the bills of Iona from the Sidehitcher account. In particular, Plaintiffs cite to Check No. 97, for $22,000, dated June 25, 2001, which was prior to the date that Sidehitcher opened a checking account. *See* Tr., p. 98, 115 and 139. The Debtor testified that many expenses came due before Sidehitcher opened its checking

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4 In their Motion for Summary Judgment, Plaintiffs erroneously argued that the unit cost was $140.

account. Tr., page 139. Yet Plaintiffs do not explain how Sidehitcher paid its bills if Iona didn't. The only explanation that Valois offered as to how the parts needed to construct 76 units could have been purchased, or how they were paid for, was that: "This financed itself." Tr., p. 61. This leaves the Debtor's explanation, which is the more believable of the two. The Debtor testified at trial:

> Q [by Debtor's counsel]: Would you explain for us at the beginning how were the books of Side Hitcher kept?
>
> DEBTOR: Okay, so the difference between Side Hitcher and Iona in the beginning was blurred. As we went forward it became clearer, because eventually Side Hitcher had a bank account and we could write checks and we could receive money into Side Hitcher. But that was fairly late.
>
> In the beginning Iona handled all the money –
>
> * * *
>
> Q: In the beginning, how was the money handled between Side Hitcher and Iona?
>
> DEBTOR: Again, what I'm trying to explain is that there really wasn't anything to pass back and forth because there was nothing on the Side Hitcher side to pass through.
>
> Q: Okay, and what was the existing – what was the seed money or the capital in the beginning that was invested by you and by Mr. Valois in Side Hitcher?
>
> DEBTOR: Well, initially there was no cash from Mr. Valois. It was strictly my money. Mr. Valois had some money that he had spent on brochures and a video, and he was claiming that that was his outlay. It was intangible. Everything required to make anything was my money.
>
> Late in the game, after I was up to almost $70,000 in debt did I go to Mr. Valois and ask him to contribute, in which case he eventually paid me $10,000. But then when he started complaining about this and that, I gave him $5,000 back, just to – you know, at that point to basically take his money out of the issue.

Tr., p. 73-75. The Debtor further testified: "As we made purchases I wrote multiple, multiple checks out of the home equity loan. What they finally totaled out to, I'm not sure. But I know it peaked at one time when I was up to $70,000." Tr., p. 82-83.

The Debtor also testified specifically as to Check No. 97:

> I was running out of cash at this point. And whenever I needed some money to be brought back to the Iona side to pay bills, I didn't come up with some hard-to-follow number. I used a round number. So $22,000 was roughly what I needed to transfer over to pay bills for that month or whatever.

Tr., p. 144-145.

Debtor also submitted after trial numerous invoices allegedly representing payments by Iona for machinery and parts used by Sidehitcher. Plaintiffs dispute these invoices on numerous grounds and argue that 36 pages of invoices actually reflect $30,000 in expenses that were paid directly from Sidehitcher's account. The Court agrees with the Plaintiffs to the extent that 24 pages of the invoices – approximately $8,000 – were paid directly from Sidehitcher's account. But Plaintiffs also credit Sidehitcher with paying for more than $25,000 in equipment invoiced to Iona – as discussed below, these invoices were paid with the Type 2 Check for equipment originally provided by Iona and used by Sidehitcher. Finally, Plaintiffs do not dispute that 38 pages of invoices totaling approximately $10,000 were expenses incurred by Iona on behalf of Sidehitcher. The invoices prove little and represent less than one-third of the $67,217.44 in parts needed to construct the Sidehitcher units according to Debtor's Exhibit B. Debtor testified that he used his home equity loan to purchased 25 engines at $350 each (a total of $8,750). Tr., p. 82. Neither these engines, nor the other 51 engines that must have been obtained, are reflected in the invoices. Debtor's bookkeeping is by no means exemplary, and there were apparently no promissory notes, invoices or other documentation for many of the expenses that the Debtor incurred on behalf of Sidehitcher individually or through Iona. In many other instances, this would be inexcusable; but for the purposes of determining whether or not the Debtor committed a defalcation, the Debtor's testimony – whether supported by documentary evidence or not – is the only

believable explanation that has been offered as to how Sidehitcher, a new company with no credit, obtained the parts and equipment[5] needed to construct the 76 Sidehitcher units.

Plaintiffs also claim that before any Sidehitcher units were built, Iona invoiced Sidehitcher $44,136 for direct labor and claim that Check Nos. 1129, 1146 and 1162 represented periodic payments on that invoice. According to Plaintiffs, the Debtor and Iona "could have no idea what the labor costs would be since it pre-dated manufacture," and that the Debtor caused Sidehitcher to pay the invoice without discussing the matter with Valois. Plaintiffs' Proposed Findings of Fact, ¶28-30. The Debtor responded that these payments were progress payments and testified that "It's very common to be building something and to invoice along the way." Tr., p. 123. The cost breakdown offered by the Debtor at trial [Debtor's Exhibit B] shows a total manufacturing cost of $298.57 per unit after costs for rework, which is a total labor cost of $22,691.32. Debtor also estimates costs of $426.67 per unit for equipment and tooling (a total cost of $32,426.92), $60 per unit for development (a total cost of $4,560) and $40 per unit for fixturing (a total cost of $3,040). Check Nos. 1129, 1146 and 1162 served as reimbursement for those costs.

Plaintiffs have failed to prove that the Debtor's receipt of any of the Type 1 checks was improper. This finding is similar to that in *Zohlman v. Zoldan*, 226 B.R. at 778, where the court held: "Since there is no evidence that Debtor wrongfully spent or failed to produce these funds, and since there is no evidence that his poor record keeping was the product of more than mere negligence, no defalcation occurred with regard to these . . . items."

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[5] As part of the unit cost breakdown, Defendant's Exhibit B includes a total materials cost of $884.44 per unit, or a total of $67,217.44 for 76 units.

The Type 2 Check

Plaintiffs also fail to show that the Type 2 check, a $29,094.13 payment from Sidehitcher to KeyBank on November 12, 2001, "had absolutely nothing to do with Sidehitcher." Following trial, Debtor submitted 12 invoices showing the purchase of $25,070.21 in equipment by Iona, which Debtor claims was used to construct the Sidehitcher units. The Debtor explained at trial that Iona borrowed $30,000 from KeyBank, and that this amount was guaranteed by the Debtor. The proceeds of the loan, totaling $29,676, were deposited with Iona on June 15, 2001. Tr., p. 16-19; Plaintiff's Trial Exhibits 2 and 4. These funds were then used to procure equipment and machinery used in the production of Sidehitcher, and the loan was secured by the equipment. Tr., p. 21. The loan was made before Sidehitcher opened a checking account, at a time when "there was no Side Hitcher from a banking standpoint," according to the Debtor. *Id.* Debtor testified as to the necessity of this equipment: "It became clear that we'd have to pay a fortune to get punching done or cutting done or bending done. So we had to buy those machines. That's why it was done." Tr., p. 138.

Plaintiffs contend that the loan to Iona was used to purchase equipment primarily for Iona, and that it was not an obligation of Sidehitcher. Debtor's testimony at trial was that the equipment was "used in 90 percent of Sidehitcher". Tr., p. 106. The better evidence that the equipment belonged to Sidehitcher is found in the testimony of Charles Valois:

> THE COURT: You testified that Side Hitcher had no equipment, is that correct?
>
> VALOIS: Yes.
>
> THE COURT: And yet you went to [Iona] and took equipment. Whose equipment was that?

VALOIS: Okay, could I explain, since that's a question I have to explain a little more than yes or no? I mean I would like to explain that to the Court, the reason –

THE COURT: But you did take the equipment?

VALOIS: Absolutely. I secured it.

THE COURT: Just let me make sure on the testimony before I let you explain. Your testimony is Side Hitcher owned no equipment. And then your testimony is that you went to [Iona] and you took equipment?

VALOIS: Yes.

THE COURT: And that I don't think I finished that, but you said you had sold all of it except a welder that you now have in your possession?

VALOIS: I only sold one unit, one piece. It was the iron worker.

THE COURT: And you now have two pieces in your possession?

VALOIS: Yes, and the third piece in question was – I don't know what happened to that, so it was only three – there was only – sorry, there was only three pieces that I took. the iron worker, the Scotchman, which is the chop saw, basically cuts metal –

THE COURT: Okay, my question is, Side Hitcher didn't own it, what right did you have to take it?

THE WITNESS: That's a good question. After Side Hitcher – after I ended up getting the – at the end when I found out that things were wrong, later in the year, [Rossitto] said he paid off Side Hitcher. He showed me these profit and loss statements. And at that time I realized what was going on. He also informed me that he was going bankrupt. He took all the money – well, from my belief here, the money also was out of the account. So my first thing was to protect, if Side Hitcher now did in fact own – not that it wanted to, but if it owned that equipment, I didn't want it to be locked up in a Bankruptcy Court.

THE COURT: And how much did you get for that equipment?

THE WITNESS: I ended up getting $6,800 because the iron worker was incomplete, and the other part was in – ended up in the bankruptcy auction [of Iona]. I have the two other pieces of equipment in my garage.

Tr., p. 73-75.

The Court concludes that the equipment was purchased for Sidehitcher and that the Debtor properly issued the Type 2 check to repay the KeyBank loan from Sidehitcher funds. The Court's finding is based upon (1) the Debtor's credible testimony that the KeyBank financing was obtained for the purposes of purchasing equipment for

Sidehitcher and was in fact used for that purpose, (2) the fact that the equipment was purchased after formation of Sidehitcher but before Sidehitcher had a line of credit or a bank account, whereas Iona had been in business for approximately 38 years (Tr., p. 31), (3) the fact that the equipment was listed as an asset on Sidehitcher's balance sheet, and (4) the testimony and acts of Charles Valois, which suggest that he, too, regarded the equipment as Sidehitcher's. Therefore, whatever the defects in the structure of the transaction, the Type 2 check does not support a finding that the Debtor committed a defalcation.

The Court also rejects Plaintiffs' argument that the Debtor should not have repaid the KeyBank loan in November 12, 2001 because Sidehitcher could have continued to make monthly payments for the 61 ½ months remaining on the term of the loan. The Debtor testified that after the initial sale of 75 units he "spent months trying to sell side hitchers to every distributor in the country" but "could not sell another single Side Hitcher" because the initial purchaser "was the only one in the United States that had the resources to support this kind of initial thing." Tr., p. 129. The Debtor further testified:

> If [the Sidehitcher] worked, they'd buy in. And if it didn't work, they wouldn't buy in. And everybody said they were going to wait and see. Well, that would mean at least one or two years before there would be another single one sold. So that's fine. I'm going out of business. I offered all of the drawings to [Valois]. I offered everything to [Valois].

Id. Under the circumstances, it was not unreasonable to repay the KeyBank loan from the proceeds of sale of the 75 units.

The Type 4 Check

The Debtor testified that the Type 4 check – a $10,000 check dated August 27, 2001 payable from Sidehitcher to the Debtor – was repayment to himself as a loan from an officer, but that no documentation existed to evidence the loan. Tr., p. 124.

Based upon the evidence and testimony at trial, the Court finds that the Debtor's receipt of the Type 4 check did not constitute a defalcation. Under the totality of the circumstances, the Debtor's issuance of the Type 4 check to himself was not an intentionally wrongful act and was made with the good-faith belief that it was for the purpose of repaying expense outlays or his return of capital. The Debtor testified that he had incurred many expenses, both directly and through Iona, on behalf of Sidehitcher. The Debtor also testified that he usually devoted six to seven days a week to the Sidehitcher business (Tr., p. 137), did not receive a profit from the sale of the Sidehitcher units (Tr., p. 140), did not receive a salary from Iona during most of 2001 (Tr. p. 154), paid Iona employees from his pocket for the work they performed on behalf of Sidehitcher (Tr. 137), borrowed up to $70,000 under a home equity loan to pay expenses of Sidehitcher (Tr. p. 78-79, 82), and partly attributes Iona's bankruptcy to too much time spent attempting to make Sidehitcher a success (Tr., p. 145). Moreover, Plaintiffs testified that Debtor invested $16,000 to $17,000 in "seed money" in Sidehitcher (Tr., p. 170).

Under these circumstances, the Debtor's self-reimbursement of $10,000 was not "inherently wrongful, illicit or morally reprehensible." *In re Hyman*, 320 B.R. at 501. Plaintiffs have not cited to any statute, case, or provision of the Sidehitcher Operating Agreement for the proposition that this payment constituted a breach of fiduciary duty. Although Plaintiff Valois has protested throughout this adversary proceeding that various acts of the Debtor were not authorized, Valois also testified that although the Sidehitcher books and records were always available to him, he delegated the responsibilities to the

Debtor, never took the opportunity to examine the books and records, and did not know how much money the Debtor had invested in Sidehitcher. Tr., p. 52-53.

Conclusion

Upon the foregoing, judgment shall be awarded to the Debtor, declaring that the debts in question are dischargeable. Debtor's counsel is hereby requested to promptly submit an order consistent with this decision.

Dated: Poughkeepsie, New York
April 8, 2005

/s/ Cecelia Morris
U.S.B.J.