UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF ALABAMA

In Re

Rhonda Veazey Pierce — Case No. 03-13249-MAM-7

Debtor

Fidelity and Deposit Company of Maryland

Plaintiff

v. — Adv. No. 03-1138

Rhonda Veazey Pierce

Defendant

ORDER PARTIALLY GRANTING AND PARTIALLY DENYING RENEWED MOTION OF PLAINTIFF FOR SUMMARY JUDGMENT

Thomas Selden, Brian Dodd, John McCall, Attorneys for the Plaintiff, Birmingham, AL
Jay Ross, Misty Gray, Attorneys for the Debtor/Defendant, Mobile, AL

This case is before the Court on the motion of the plaintiff, Fidelity and Deposit Guaranty of Maryland, for summary judgment against defendant, Rhonda Veazey Pierce, declaring a debt she owes to it nondischargeable. This Court has jurisdiction to hear this case pursuant to 28 U.S.C.§ § 157 and 1334 and the Order of Reference of the District Court. This motion is a core proceeding pursuant to 28 U.S.C. § 157(b)(2) and the Court has the authority to enter a final order. For the reasons indicated below, the Court is partially granting plaintiff's motion for summary judgment and partially denying it.

FACTS

Rhonda Veazey Pierce was the guardian of the estates of her minor children, Lyman Mack Veazey, IV, and Chastity Elizabeth Veazey. She was appointed guardian on April 14, 1983 by the Probate Court of Mobile County, Alabama. Fidelity and Deposit Guaranty of Maryland issued separate bonds on Pierce's behalf bonding her as guardian of each estate.

In 1994 Lyman's account had a balance of $18,030.60 in it and Chastity's had a balance of $20,190.50. At some point in time in or after 1994 that money was depleted. Ms. Pierce and the bonding company were sued by Lyman and Chastity Veazey and on July 28, 2000, Judge Frank H. Kruse awarded judgments to the children in the amount of $11,530.60 for Lyman and $13,690.50 for Chastity.

The judge made findings of fact and conclusions of law that are in evidence. He stated:

> [I]n 1994 something happened, whether this be . . . alcohol or gambling or a combination of both, the record shows and the evidence shows, as well as the parties' stipulations, that she expended money that was not on the behalf of these children; that she in fact used their money for her own purposes. . . [B]ased on us being here for four days, that I've heard all of the evidence and that she's not convinced me that the money that she spent from November of 1994 was used in any way for the children. In fact, it appears quite the opposite. . . .
> But nobody can provide me with any evidence as to what happened to the differences between the previous balances that I just stated.

The formal judgment was entered on September 6, 2000. Fidelity and Deposit Guaranty paid the children and, as surety, now stands in their shoes. On September 19, 2001, the Probate Court entered a further judgment awarding Fidelity and Deposit Guaranty a judgment for $57,263.13 of which $32,042.02 is attorneys fees added to the original judgment of $25,221.11.

LAW

The plaintiff, Fidelity and Deposit Guaranty asserts that the entire debt owed to it by Ms. Pierce is a nondischargeable debt pursuant to 11 U.S.C.§ 523(a)(4). Section 523(a)(4) states:

> A discharge under section 727 . . . of this title does not discharge an individual from any debt--
>
> * * * *
>
> (4) for fraud or defalcation while acting in a fiduciary capacity

This is a motion for summary judgment and it is controlled by Rule 56 of the Federal Rules of Civil Procedure, which has been made applicable to bankruptcy proceedings pursuant to Fed. R. Bankr. P. 7056. A court shall grant summary judgment to a party when the movant shows that "there is no genuine issue as to any material fact and . . . the moving party is entitled to judgment as a matter of law." Fed. R. Bankr. P. 7056(c). In *Anderson v. Liberty Lobby, Inc*., 477 U.S. 242, 106 S. Ct. 2505, 91 L. Ed. 2d 202 (1986), the Supreme Court found that a judge's function is not to determine the truth of the matter asserted or weight of the evidence presented, but to determine whether or not the factual disputes raise genuine issues for trial. *Anderson*, 106 S. Ct. at 2510-511. In making this determination, the facts are to be looked upon in the light most favorable to the nonmoving party. *Id.*; *Celotex Corp. v. Catrett*, 106 S. Ct. 2548, 91 L. Ed.2d 265, 477 U.S. 317, 323 (1986).

A.

In order for section 523(a)(4) to be applicable to this case, Ms. Pierce must be a fiduciary and Ms. Pierce's actions must have been a defalcation or a fraud. Ms. Pierce admits that as a guardian of a minor's estate, she is a fiduciary for purposes of the statute. Case law clearly holds

that a guardian is a fiduciary covered by the statute. *Quaif v. Johnson*, 4 F.3d 950 (11th Cir. 1993); *Peerless Insurance v. Swanson (In re Swanson)*, 231 B.R. 145 (Bankr. D.N.H. 1999).

B.

The next issue is whether there has been a fraud committed by Ms. Pierce as guardian. Fraud under section 523(a)(4) is the same fraud as that required under section 523(a)(2)(A) of the Bankruptcy Code. *McDaniel v. Border (In re McDaniel),* 181 B.R. 883 (Bankr. S.D.Tx. 1994). The debtor must: (1) misappropriate monies (2) know that she was misappropriating monies (3) do so intentionally, and (4) cause a loss to the other party. *Id.* In this case, the evidence in the transcript does not state that Ms. Pierce acted intentionally. The judge indicates that alcohol and/or gambling caused the problem, but his findings did not show intent to harm. Summary judgment must be denied as to fraud while acting in a fiduciary capacity.

C.

The more difficult question is whether Ms. Pierce has committed a defalcation in her actions as a guardian according to the evidence. Defalcation, as that term is used in section 523(a)(4), has been defined by the Eleventh Circuit[1] as "a failure to produce funds entrusted to a fiduciary." *Quaif*, 4 F.3d at 955. Such a failure can be intentional, reckless, negligent or innocent. In the *Quaif* case, the debtor's actions resulting in the nondischargeable defalcation were intentional, being "far more than innocent mistake or even negligence." *Quaif*, 4 F.3d 955. Therefore, in the Eleventh Circuit an intentional action is a defalcation that is not dischargeable. *Quaif* acknowledges that the law is not clear as to what other types of actions are

[1]The Court opinion in *Quaif* is actually an adopted District Court opinion of Judge Orinda D. Evans of the Northern District of Georgia.

nondischargeable defalcations. All cases would hold an intentional or fraudulent act is a defalcation. The grayer area is whether reckless, negligent or even innocent actions of a person can be defalcations. *Id.*; *SunTrust Bank v. Roberson (In re Roberson)*, 231 B.R. 136, footnote 3 (Bankr. S.D.Ga. 1999); *Houston v. Capps (In re Capps)*, 193 B.R. 955,966, footnote 6 (Bankr. N.D. Ala. 1995). The *Quaif* court's stated:

> [T]he precise meaning of "defalcation" for purposes of § 523(a)(4) has never been entirely clear. . . An early, and perhaps the best, analysis of this question is that of Judge Learned Hand in *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937). Judge Hand concluded that while a purely innocent mistake by the fiduciary may be dischargeable, a "defalcation" for purposes of this statute does not have to rise to the level of "fraud," "embezzlement," or even "misappropriation." *Id*. at 512. Some cases have read the term even more broadly, stating that even a purely innocent party can be deemed to have committed a defalcation for purposes of § 523(a)(4).
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> 4 F.3d at 955 (cites omitted).

The First, Fifth, and Seventh Circuits hold that reckless defalcations are nondischargeable misappropriations, but negligent and innocent defalcations are dischargeable in bankruptcy. *Rutanen v. Baylis (In re Baylis)*, 313 F. 3d 9 (1st. Cir. 2002); *Schwager v. Fallas (In re Schwager)*, 121 F.3d 177, 184 (5th Cir. 1997)(holding the same); *Meyer v. Rigdon*, 36 F.3d 1375 (7th Cir. 1994)(same). Other cases hold that negligent and even innocent defalcations are nondischargeable pursuant to section 523(a)(4). *Antlers Roof-Truss & Builders Supply v. Storie (In re Storie)*, 216 283 (10th Cir. BAP 1997); *Resources, Inc. v. Merrill (In re Merrill)*, 246 B.R. 906 (Bankr. N.D.Okla. 2000).

The cases that hold that negligent and mistaken or innocent defalcations are not dischargeable look at the language of section 523(a)(4). It does not differentiate among levels of defalcation. It states that defalcations while acting in a fiduciary capacity are nondischargeable.

These courts conclude that a fiduciary acting in a way that harms a beneficiary is a serious issue, regardless of the fiduciary's intent.

The First, Fifth and Seventh Circuits hold otherwise. In the case of *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 20 (1st Cir. 2002) the Court of Appeals held that "to show defalcation, a creditor need not prove that a debtor acted knowingly or willfully, in the sense of specific intent. However, a creditor must be able to show that a debtor's actions were so egregious that they come close to the level that would be required to prove fraud, embezzlement, or larceny." The Court made a thoughtful analysis of the policy and statutory interpretation reasons for this view. All other sections of 523 that deal with nondishchargeable debts deal (1) with serious actions or inactions by debtors or-fraud, embezzlement, larceny, willful and malicious injuries, drunken operation of vehicles, etc; or (2) with situations where repayment is important for policy reasons--taxes, family support obligations, student loans, restitution, etc. None envision innocent or even wholly negligent behavior. Sweeping innocent or negligent behavior into section 523 would also directly negate the "fresh start" policy of the Bankruptcy Code. *Baylis* at 313 F.3d 19.

The *Baylis* case is similar to this case and contains a thoughtful analysis that is appropriate for use in this case and this Court adopts it. The First Circuit distinguished between negligent/innocent and reckless actions of fiduciaries. In the *Baylis* case a trustee of a testamentary trust was asserted to have violated (1) his duty of loyalty to the beneficiaries by using trust funds for his own benefit and(2) his duty of reasonable care by his failure to sell trust property when appropriate.

The First Circuit held that a violation of the duty of loyalty was presumptively a defalcation. *Baylis*, 313 F.3d 20-21. This is due to the "very high and very strict standard for [a

fiduciary's] conduct whenever his personal interest comes or may come into conflict with his duty to his beneficiaries." *Id*. (citing 2A A.Scott, *The Law of Trusts* § 170.25). When a trustee puts his or her own self interest above a trust's beneficiaries, the standard of behavior to which he or she is held is "more rigorous." *Baylis*, 313 F.3d 21 (citing 2A A.Scott, *The Law of Trusts* § 170.25).

The First Circuit held that a duty of care violation was only a defalcation if the trustee acts recklessly. There is no presumption of defalcation. The duty of care for a trustee can be violated if the trustee does not act reasonably. *Baylis*, 313 F.3d 22. Such an action is not always reckless. For instance, a trustee might make poor investments that are only clearly poor in hindsight or a trustee might sell an asset for a lesser amount than might be realized with more diligence. Mistakes that only appear unwise in hindsight or due to poor investment advice from qualified consultants would not be actionable. However, if a trustee chooses very risky investments or fails to get competent investment advice when the trustee knows he is not qualified to make serious investment decisions, these actions might be reckless.

This Court concludes that the First Circuit's view of the necessary intent is correct. Innocent or mistaken activity will not be sufficient for a debt to be nondischargeable as a defalcation, nor will negligent behavior. However, reckless behavior is sufficient to constitute a defalcation. The Court concludes that this view is appropriate because including negligent defalcation as a section 523(a)(4) debt would prevent discharge of debts in situations that are not of the serious nature as the other debts covered by § 523. A trustee who negligently violates the duty of reasonable care of trust assets would be swept into the category of persons with

nondischargeable debts. Judgment errors that are not intentionally or recklessly harmful should not be covered.

In this case, Judge Kruse's analysis does not state that Ms. Pierce's actions were fraudulent or intentional. It does state that her actions were a result of alcohol or gambling and that Ms. Pierce used her wards' "money for her own purposes." These words show that her actions violated the duty of loyalty. Ms. Pierce used her children's money for her benefit. As *Baylis* [2] states, this is a presumed defalcation. No evidence offered overcame that presumption. Violation of the duty of loyalty is proof of recklessness. Furthermore, alcohol and gambling as a reason for the improper use of funds adds to its reckless nature. Therefore, the motion for summary judgment should be granted as to this point.

D.

The debtor asserts that the debtor should only be liable for money missing from the children's estates should the debt be declared nondischargeable. The attorneys fees should not be included. Fidelity & Deposit Guaranty asserts that the entire judgment against Ms. Pierce is nondischargeable. The Eleventh Circuit has ruled in the *TranSouth Financial Corp. of Florida v. Johnson* case, 931 F.2d 1505 (11th Cir. 1991) that attorneys fees resulting from a creditor's actions to collect its debt are nondischargeable if a contract or statute provides for the award of fees. There is a split of authority among the courts on this issue, but it is clear in this Circuit. *Beneficial National Bank v. Priestley (In re Priestley)*, 201 B.R. 875,886-87 (Bankr. D.Del. 1996).

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[2] *Baylis*, 331 F.3d 20-21.

Fidelity has not produced evidence of any statute or contract to date that provides liability on Ms. Pierce's part for attorneys fees and costs. Therefore, summary judgment on this point must be denied.

IT IS ORDERED that:

(1) the renewed motion for summary judgment is GRANTED as to the nondischargeability of $25,221.11 pursuant to 11 U.S.C. 523(a)(4) and is DENIED without prejudice as to the attorneys fee issue; and

(2) Trial of the remaining issue of attorneys fee in this case is set on **June 29, 2004 at 10:00 a.m.**, Courtroom 2, U.S. Bankruptcy Court, 201 St. Louis Street, Mobile, AL 36602.

Dated: April 15, 2004

Margaret A. Mahoney

MARGARET A. MAHONEY
U.S. BANKRUPTCY JUDGE