

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF TENNESSEE
WESTERN DIVISION

IN RE:

JOHN W. WALKER and
IPRIMA WALKER,

BK #88-26163-WHB
Chapter 7

Debtors.

TRAVELERS EXPRESS COMPANY, INC.,

Plaintiff,

v.

Adversary Proceeding
No. 88-0273

JOHN W. WALKER,

Defendant.

MEMORANDUM OPINION AND ORDER
REGARDING PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT

This core proceeding¹ is before the Court on the motion of Travelers Express Company, Inc. (the plaintiff) for summary judgment on its complaint to determine the dischargeability of its debt pursuant to 11 U.S.C. §523(a)(4). At issue is whether the plaintiff may be granted a summary judgment pursuant to Bankruptcy Rule 7056.

The pleadings and exhibits filed thus far in this cause reflect that the debtors filed a joint, voluntary petition for Chapter 7 relief on August 25, 1988. Prior to that time, they were the owners of Walbos, Inc. which did business under the name of "Kash 'n Karry."

On July 10, 1985, the defendant here, John Walker, executed an agreement with the plaintiff on behalf of his business, Walbos, Inc. d/b/a Kash 'n Karry, for the purpose of enabling his business to sell the

¹ 28 U.S.C. §157(b)(2)(l)

plaintiff's money orders to its customers. The agreement, styled "Trust Agreement" is signed by the defendant as "manager owner."

As part of the agreement, the defendant agreed to "hold in trust" for the plaintiff "all money received from the issuance and sale of money orders . . . hereinafter called 'trust funds,' separate and apart from other funds." In addition, the debtor-defendant signed a personal guaranty and agreement to indemnify the plaintiff against any loss, including attorney's fees, sustained by it as a result of or related to the defendant's "failure to perform" the above described agreement. (Ex. A to complaint)

Subsequently, an audit of the business records was completed on October 15, 1986. This audit revealed a "shortage" of \$78,094.92 in funds due the plaintiff. (Ex. B to complaint)

On that same date, the defendant signed a statement wherein he admitted having violated the agreement "by having used trust funds in the amount of \$78,094.92, accumulated from the sale and issue of money orders to satisfy pressing obligations." By this same statement, the debtors personally agreed to make full restitution of the amounts due. (Ex. C to complaint)

According to paragraph 12 of the complaint, after allowing all credits to which the debtor was entitled, it was determined that the principal indebtedness due the plaintiff was \$65,594.92. The plaintiff filed suit against the debtor for this amount in Shelby County Circuit Court and on January 22, 1988, was awarded a default judgment in the amount of \$65,594.92 plus attorney's fees of \$10,000.00 and pre-judgment interest of \$7,908.03. As such, it is the plaintiff's position that it is entitled to a nondischargeable judgment against the defendant for these amounts totalling \$83,502.95.

In his answer, the defendant has admitted to execution of the Trust Agreement and guaranty as well as the asserted terms of the Trust Agreement. He has further admitted breaching the trust agreement by failing to remit trust funds. In addition, he has admitted that the audit revealed a shortage of \$78,094.92 in the trust funds and that he signed the statement acknowledging that fact.

Because the complaint asserts violations of 11 U.S.C. §523(a)(2)(A) and §523(a)(6), the debtor has denied engaging in any fraudulent activity, obtaining money by false pretenses, and improper conversion of

the funds or knowledge thereof. He asserts that he did not pay all obligations personally as a bookkeeper had some of the responsibility and that all funds were combined in one account. Moreover, the debtor denies the plaintiff's assertions that he is indebted to the plaintiff in the amounts of \$65,594.92, \$10,000.00 and \$7,908.03 pursuant to a Circuit Court judgment. He further denies any liability under §523(a)(4) of the Bankruptcy Code pursuant to which the plaintiff has brought the instant motion for summary judgment.

Bankruptcy Rule 7056, which incorporates Federal Rule 56, governs the availability of summary judgments in adversary proceedings pending in the bankruptcy context. Pursuant thereto, "[t]he judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Federal Rule of Civil Procedure 56(c).

As noted above, the plaintiff's motion for summary judgment in this proceeding is based upon the defendant's alleged violation of 11 U.S.C. §523(a)(4). This section provides, in pertinent part:

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

According to the plaintiff, the indebtedness due it arose from the defendant's defalcation while acting in a fiduciary capacity and as such, the plaintiff is entitled to a judgment as a matter of law.

The defendant asserts that questions of fact and law are raised by the defendant's answer. With respect to the §523(a)(4) allegations, these questions are whether the debtor acted in a fiduciary capacity and whether a fraud or defalcation actually occurred.

It is well settled that the burden of proving an exception to discharge is placed upon the objecting creditor. Where, as here, the issue is one of defalcation while acting in a fiduciary capacity, the plaintiff must prove that "the debt arose (1) from defalcation; and (2) while the debtor was acting in a fiduciary capacity as a result of an express trust." In re Manzo, 106 B.R. 69, 71 (Bankr. E.D. Pa. 1989). Moreover, "defalcation

need only be proven by a preponderance of the evidence, while the express trust must be established by clear, precise, and unambiguous evidence." Id. It may be concluded from this language that the initial determination should be whether there exists a fiduciary relationship.

In order to establish the existence of a fiduciary relationship for dischargeability purposes it must be shown that an express and technical trust existed between the parties prior to the creation of the debt in controversy. In other words, constructive or resulting trusts do not establish the type of fiduciary relationship contemplated by §523(a)(4). In re Niven, 32 B.R. 354, 356 (Bankr. W.D. Ok. 1983); In re Guy, 101 B.R. 961, 983 (Bankr. N.D. Ind. 1988). Moreover, the trust may not be one merely arising or implied from a contract. In re Niven, 32 B.R. at 356. Even the fact that a commercial agreement contains the word "trust" does not make the agreement a trust agreement nor create a fiduciary relationship for dischargeability purposes. Rather, "it is the substance and character of the debt relationship that determines whether a fiduciary relationship exists." In re Guy, 101 B.R. at 983.

The existence of a fiduciary relationship is a question of federal law but, as the above discussion indicates, it is dependent on the determination that an express trust pursuant to state law exists between the parties. In re Niven, *supra*; In re Guy, *supra*.

For our purposes, in this regard, Tennessee law dictates that the existence of a trust agreement requires proof of three elements:

- (1) a trustee who holds a trust property and who is subject to equitable duties to deal with it for the benefit of another;
- (2) a beneficiary to whom the trustee owes equitable duties to deal with the trust property for his benefit;
- and (3) identifiable trust property.

Kopsombut-Myint Buddhist Center v. State Board of Equalization, 728 S.W. 2d 327, (Tenn. App. 1986). See also, In re Elrod, 42 B.R. 468 (Bankr. E.D. Tenn. 1984); In re Property Leasing and Management, Inc., 46 B.R. 903 (Bankr. E.D. Tenn. 1985).

In the case at bar, as discussed above, the parties executed an agreement styled "Trust Agreement." In pertinent part, the agreement provides:

THIS TRUST AGREEMENT made between TRAVELERS EXPRESS COMPANY, INC. . . . (hereinafter called "the company") and WALBOS, INC. doing business as Kash & Karry at 1500 South Lauderdale, Memphis, Tn. 38106, a corporation (herein called "Agent") whereby it is agreed between them as follows:

1. Appointment of Agent. The company appoints Agent as its trustee and agent for the sale of the company's money orders at each of Agent's existing, relocated, or future places of business. Agent shall comply with all instructions hereafter issued to Agent by the Company and with all applicable laws. Agent hereby accepts such appointment and agrees to sell no money orders except those of the company at any of Agent's existing, relocated or future places of business.

2. Trust Relationship Agreement. Agent shall receive and hold in trust for the Company all blank money orders delivered to Agent by the Company and all money received by Agent from the issuance and sale of money orders (except Agent's commission), hereinafter called "trust funds," separate and apart from other funds. If agent commingles the trust funds with other funds, the total commingled funds shall constitute the trust funds and shall belong to and be payable to the Company to the extent necessary to secure the payment of all moneys payable by Agent to the Company.

From this language, the Court can conclude, notwithstanding the use of the term "Agent," that the agreement in fact created an express trust agreement under Tennessee law in that it identifies trust property and clearly designates the "agent" as trustee of the funds received from the issuance of money orders while designating the "company" as beneficiary.

The question thus becomes whether the defendant here may be personally liable given that the agreement refers to Walbos, Inc. as the trustee. According to several courts which have considered this issue,

[a]lthough it is generally understood that a corporate officer, director or shareholder is not liable as a fiduciary under §523(a)(4) for corporate debts owed to the corporation's creditors, an exception exists when the corporation is entrusted with funds for a particular purpose and the debt owed to the creditor bears a special relationship to the funds.

In re Manzo, 106 B.R. at 72 (citations omitted). See also In re Niven, 32 B.R. at 356; In re Guy, 101 B.R. at 985.

Given this exception, in light of the fact that there exists here an express trust between the plaintiff and the debtor's corporation, it follows that there is likewise an express trust between the plaintiff and the

debtor. This conclusion is further supported by the facts that the defendant personally signed the Trust Agreement as "manager owner," that he personally guaranteed to indemnify the plaintiff for any losses incurred from the debtor's failure to perform under the agreement, and that he personally signed the acknowledgement of loss.

Having found that an express trust existed between these parties, the Court concludes that the defendant was in fact personally acting in a fiduciary capacity when dealing with the funds received from the sale of the plaintiff's money orders. See, e.g., In re Niven, supra. It must next be determined whether a defalcation occurred.

For purposes of §523(a)(4), defalcation is defined as "the failure of a fiduciary to properly account for funds entrusted to him." In re Manzo, 106 B.R. at 72. Moreover, it is irrelevant whether the fiduciary was engaged in wrongdoing or was negligent or ignorant of the misappropriation. Rather, defalcation includes any failure by the fiduciary to properly account for entrusted funds. There need not be a personal gain to the fiduciary. Id. (citations omitted)

There is no dispute in the case at bar that the defendant has failed to properly account for entrusted funds. In fact, the defendant has admitted such both in his answer filed in this proceeding and in the statement signed at the time the deficiency was discovered.

In light of these circumstances, it may be concluded that defalcation has occurred in this case. Thus, the plaintiff is entitled to a summary judgment on the issue of whether the principal debt here arose as a result of the defendant's defalcation while acting in a fiduciary capacity.

This leaves the question of whether the plaintiff is also entitled to a nondischargeable judgment for the attorney's fees and interest awarded in the default judgment granted by the Circuit Court. Because the Circuit Court judgment was one of default, the granting of the interest and attorney's fees may not be given preclusive effect because the issues were not actually litigated. See, Ferrieli, "The Preclusive Effect of State Court Decisions in Bankruptcy," 58 Am. Jur. L.J. 349 at 364 (1984).

The Trust Agreement itself provides that the debtor shall "unequivocally indemnify the [plaintiff] against all loss, expense and/or damages (including interest) sustained by the [plaintiff] as a result, in whole or in part, of any act or omission to act, whether honest, dishonest, negligent, or otherwise by the [debtor] or by debtor's employees . . . in breach of the Agreement. Damages or indemnity . . . shall in every case include reasonable costs and attorney's fees whether or not suit is commenced." Similar language is found in the personal guaranty.

The Sixth Circuit has held that where there is a contractual right to attorney's fees which is valid under state law, creditors are entitled to recover fees in the bankruptcy context. In re Martin, 761 F.2d 1163, at 1168 (6th Cir. 1985). Although this holding was rendered in a case involving the dischargeability of a debt pursuant to §523(a)(2)(B), this Court finds no reason why it should not be applicable to §523(a)(4) issues particularly in light of the Sixth Circuit's determination that "a contractual right to attorney's fees is part of the debt to the creditor and is not dependent on an award of costs." Id. In reaching this determination, the Martin Court reasoned that "§523(a)(2)(B) excepts from discharge the whole of any debt incurred by use of a fraudulent financial statement, and such a debt includes state-approved contractually required attorney's fees." Id.

By analogy, §523(a)(4) excepts from discharge the whole of any debt incurred from "defalcation while acting in a fiduciary capacity." In this case, the "whole debt" includes the state-approved, contractually required attorney's fees.

The agreement between these parties additionally provided for the payment of interest on any claim arising from the debtor's failure to perform thereunder. Unless unreasonable, such provisions are generally enforced in Tennessee just as attorney's fees provisions are enforced. See, T.C.A. §47-14-123; Emrich v. Samford, 39 B.R. 423 at 427 (Bankr. M.D. Tenn. 1984). Therefore, application of the above concept to the interest issue leads to the determination that interest also may be said to be a part of the whole debt which is subject to exception from discharge under §523(a)(4).

From these findings, it appears that the plaintiff is entitled to a summary judgment on the issue of whether its debt, including attorney's fees and interest, may be excepted from the debtor's general discharge pursuant to §523(a)(4). However, there is apparently some factual dispute as to the amount of the indebtedness and, as such, the plaintiff's counsel is instructed to provide the defendant's counsel with proof of these amounts; i.e., principal, interest, and attorney's fees, and their reasonableness within 30 days of the entry of this memorandum opinion and order. This matter shall be reset for February 20, 1990 at 10:00 a.m. in Courtroom 1250, 969 Madison Avenue, Memphis, Tennessee for a status conference regarding resolution of this issue. If no such resolution is forthcoming, a hearing for the purpose of presenting evidence on the amount of the debt shall be scheduled following the status conference. If the issue of the amount of the debt is resolved, plaintiff's counsel shall prepare an order reflecting such.

From the foregoing, it is **HEREBY ORDERED** that:

The motion of Travelers Express Company, Inc. for a summary judgment on its complaint to determine the dischargeability of its debt pursuant to 11 U.S.C. §523(a)(4) is **GRANTED** and the debt is excepted from discharge; and

The amount of the nondischargeable judgment is to be ascertained in accordance with the above instructions.

SO ORDERED THIS 9th day of January, 1990.

WILLIAM HOUSTON BROWN
UNITED STATES BANKRUPTCY JUDGE

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