(Cite as: 1987 WL 19488 (Bankr.D.Vt.))

In re Denis Patrick RUDD and Julia A. Rudd, Debtors,

James R. Lavigne, Esq., a Personal Representative of the Estate of Anne D.

McMahon, Jeremiah McMahon and John McMahon, Plaintiff,

v.

Denis Patrick RUDD and Julia A. Rudd, Defendants.

Bankruptcy No. 85-211.

Adv. Nos. 85-81, 85-82.

United States Bankruptcy Court, D. Vermont.

Sept. 29, 1987.

G. Harley, Bennington, Vermont, for debtors (Rudd).

J. Lavigne, Maitland, Florida, and T. Pressly, Rutland, Vermont, for the Estate of Anne D. McMahon, Jeremiah McMahon and John McMahon (plaintiff).

MEMORANDUM DECISION DETERMINING DEBT TO BE NONDISCHARGEABLE UNDER 11 USC §

523(A)(4).

FRANCIS G. CONRAD, Bankruptcy Judge.

***1** Denis Patrick Rudd was appointed the personal representative of the estate of the testatrix, Anne D. McMahon, in August, 1982. The estate was domiciled, as was Mr. Rudd at the time, in Florida. Immediately following his appointment, the two beneficiaries of the estate petitioned to have him removed. The removal petition was denied for reasons not disclosed to us.

From August 1982 until December 1984, when he was removed from his position as the personal representative of the estate, Mr. Rudd lost the entire corpus of the estate, except for: $1,016.26, money paid to the Internal Revenue Service and the Florida Department of Revenue; $106,000.00 distributed to the beneficiaries; and, some paintings returned to the beneficiaries. The exact amount of the loss including expenses of administration is calculated in an Appendix attached to this Decision.

Mr. Rudd lost the estate principal by investing in stocks, puts and calls (options), and commodities. His testimony shows he had the requisite educational background to invest in stocks, but he demonstrated he knew little or nothing about puts and calls or commodities except that he could lose alot of money in options, which he did. He claims he didn't know commodities were speculative investments. The parties stipulated, however, that trading in commodities was speculative and an improper investment for a Florida fiduciary.

The losses occurred early in his administration. Despite his deplorable track record, and in an attempt to recoup the losses, he invested Seventy Thousand Dollars of his own money and Fifty Eight Thousand Dollars from his daughter's guardship. [FN1] He lost all of this money as well.

During the course of the estate administration he corresponded with the beneficiaries and his attorneys but never told them he was investing the money as he did, or that he transferred funds from Florida to Vermont bank accounts.

Denis Rudd unquestionably breached his fiduciary obligation as the personal representative of the estate by hopelessly mismanaging the funds entrusted to his care. In depleting a considerable estate through such imprudent and highly risky endeavors as puts and calls, and commodities, he acted in reckless disregard of his duty to the beneficiaries of the estate. He was, in short, guilty of devastavit.

It is equally clear that though he performed his office incompetently, at best, he did not act intentionally or dishonestly. He achieved no personal gain from investments, and in fact, lost $78,000.00 of his own money in a reckless effort to recoup the depleted estate. He was able, moreover, to account fully for the funds involved.

Plaintiff filed an objection to discharge against Rudd under 11 USC § 727(a)(2), (a)(3), (a)(4)(A), and (a)(7), [FN2] and a complaint objecting to discharge of a debt under 11 USC § 523(a)(4) [FN3] and (a)(6). [FN4] After several preliminary procedural skirmishes both matters were set for a combined trial on the merits.

At the onset of the trial, plaintiff agreed on the record to withdraw its § 727(a)(2) complaint but did not withdraw what it stated was its § 727(a)(4), (a)(5), and (a)(6). When we asked whether it was relying on § 727(a)(4), counsel for plaintiff responded "(a)(5)." At the time of trial we were confused by plaintiff's counsel about the basis of all of the § 727 actions and dismissed them summarily. Plaintiff's counsel did not object to our dismissal. To ensure a complete record we again sustain our dismissal of the § 727 actions.

***2** We find no evidence to indicate infractions within the parameters of § 727(a)(2), (a)(3), (a)(4)(A), or (a)(7), or for that matter, although not stated in the complaint but raised at trial, (a)(5). While the evidence does reveal that Rudd was slow to produce discovery documents, there was no showing of intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of estate property, nor did plaintiff establish any impression of § 727(a)(3) behavior by Rudd. As to § 727(a)(4), we find the debtor to be credible. No evidence was introduced at all under § 727(a)(5) even though plaintiff thought this subsection was where its objection had some substance. Finally, we don't understand how § 727(a)(7) applies to this case. To this Court's knowledge, we have no other cases pending before us where the debtor may have an insider relationship.

Plaintiff advanced a significant amount of evidence at trial which ultimately showed that Rudd did indeed breach his fiduciary obligation by the terms of 11 USC § 523, however, in both its § 727 objection and its complaint under § 523(a)(4) and (a)(6), plaintiff also included Mrs. Rudd.

Plaintiff introduced evidence which showed that Mrs. Rudd's name was on some joint Vermont bank accounts which held or received estate funds. Mrs. Rudd, however, had no knowledge of these accounts. Plaintiff also showed that Mrs. Rudd occasionally acted as her spouse's secretary. But plaintiff showed no more accountability on Mrs. Rudd's part than her name on some of the Vermont bank accounts and occasional secretarial duties. Plaintiff failed to show that Mrs. Rudd was a fiduciary. The statute requires as a prerequisite to nondischargeability under § 523(a)(4) that the debtor commit an act of defalcation while acting in a fiduciary capacity. See i.e., Blackhawk B.M.X., Inc. v. Anderson (In re Anderson), 64 BR 331 (Bkrtcy.N.D.Ill.1986) (creditor must prove that debtor committed a defalcation while a fiduciary). "The qualification that the debtor be acting in a fiduciary capacity has consistently, since its appearance in the Act of 1841, been limited in its application to what may be described as technical or express trusts, and not to trusts ex-maleficio that may be imposed because of the very act of wrongdoing out of which the contested debt arose." 3 Collier on Bankruptcy, § 523.14, page 523-93, (1986) (footnote omitted). Compare Carlisle Cashway, Inc. v. Johnson (In re Johnson), 691 F.2d 249, 253 (6th Cir.1982) (The trust must exist separate from the act of wrongdoing and not arise ex-maleficio.).

Finally, looking at plaintiff's § 523(a)(6) complaint in relation to Mrs. Rudd, not a scintilla of evidence was produced that showed she acted in a manner that was willful and malicious, let alone that she proximately caused any injury to the plaintiff. Accordingly, all causes of action against Mrs. Rudd will be dismissed.

The remaining issue to be decided by us is whether Denis Patrick Rudd, who did not act dishonestly or intentionally but rather, incompetently, and who did not personally gain when he breached his fiduciary obligation, should be excepted from discharge under 11 USC § 523 (a)(4) and (6).

***3** The word "defalcation" first appears in § 1 of the Act of 1800, 5 Stat. 440, and only as part of the definition of those who might become voluntary bankrupts; they were those who did not owe debts "created in consequence of a defalcation ... as executor ..." It was limited to "special" or "technical" fiduciaries. Chapman v. Forsyth, 2 How. 202, 11 L.Ed. 236, 238 (1844). As Congress enacted and reenacted the various Bankruptcy Acts, defalcation appeared and reappeared between fraud and embezzlement, or next to them, or before them, but "whatever was the original meaning of 'defalcation,' it must ... (referring to the 1898 Act, 11 USCA § 35(4)) have covered other defaults than deliberate malversations, else it added nothing to the words, 'fraud' or 'embezzlement.' " (J. Hand) Central Hanover Bank & Trust v. Herbst, 93 F.2d 510, 511 (2d Cir.1937). We know from Herbst, id., that "defalcation" is not "embezzlement." Nor is it "fraud" or perhaps not even "misappropriation." But rather, it implies some moral dereliction, which may include innocent default and some misconduct.

As defined by the District Court in In re Herbst, 22 F.Supp. 353 (S.D.N.Y.19370, affirmed, 93 F.2d 510 (2d Cir.1937), and we perceive no reason to doubt that this definition remains true today, " 'defalcation' means the failure of one who has received moneys in trust to pay it over as he ought. It is a broader word than fraud, embezzlement, or misappropriation, and covers cases where there was no fraud, embezzlement, or willful misappropriation on the part of the bankrupt." In re Herbst, id., at 354.

There is a certain tension in our nation's bankruptcy laws that has long been recognized concerning the dischargeability of debts. On one hand, there is the fundamental goal to afford a deserving debtor an economic rehabilitation or "fresh start" in life which requires a narrow and strict interpretation of the exception to discharge.

On the other hand, we have Congress' intent clearly stated in the statute that a discharge is not granted "an individual debtor from any debt ... for ... defalcation while acting in a fiduciary capacity ..." 11 USC § 523(a)(4). This statute is unequivocal. It requires no intent, no misconduct, no personal gain, nor does it allow for ignorance. In dicta, Judge Hand in Herbst, supra, 93 F.2d, at 512, implied that "defalcation" may demand some portion of misconduct. We find no such limitation in the present statute. Compare American Metals Corporation v. Cowley (In re Cowley), 35 BR 526 (Bkrtcy.D.Kan.1983) (no personal gain or misconduct required, since negligence or ignorance may be "defalcation").

We are aware of those cases that define "defalcation" as a general failure to account for money, or property that has been entrusted to a fiduciary, See i.e., Cowley, id., at 529, but we are required to follow the precedent set by this Circuit in Herbst, supra, 93 F.2d, at 511, which states: " 'defalcation' ... include(s) all fiduciaries who for any reason were short in their accounts." The debtor here is able to account for his losses, but unfortunately, he is short in his accounts.

***4** We are made aware by the evidence, and so find, that Rudd acted without malice, but only out of ignorance, and did not personally gain from his activities. As such, we cannot merit the § 523(a)(6) complaint. But we must hold that the debt is nondischargeable under § 523(a)(4).

Because counsel for both sides ablely represented their clients, in order to foster judicial economy at both the State and Federal levels and to end the costs of litigation for all parties, we have appended to this Memorandum a calculation of the debt to be determined nondischargeable.

An appropriate Order and Judgment shall be entered.

APPENDIX A [FN1]

(cents omitted)

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PRINCIPAL RECEIVED: $431,618 [FN2]
LESS:
Payment to IRS--$42,617
Estate Tax net of refund (5,093)
Payment to Florida Dept. of Revenue 8,603
Partial Distr. to Beneficiaries 106,000 [FN3]
Expenses of Fiduciary 5,000
Tax on Savings Plan 8,000
Tax on Sale of Condo 7,000
Memorial Chapel 556
Cemetery 251
Secretarial 250
Clerical Supplies 150
Telephone 500
Accounting Services 300
Principal Accounted For 1,016 <180,243>
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DEBT NONDISCHARGEABLE: $251,375
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FN1. In a matter not before this Court, Mrs. Rudd had Mr. Rudd removed as guardian of their infant daughter's estate and recovered from a bonding company most of the Fifty Eight Thousand Dollars.

FN2. The relevant subsections of 11 USC § 727 provide: "(a) The court shall grant the debtor a discharge, unless--

(2) the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated or concealed ... property of the debtor ... property of the estate ...

(3) the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case;

(4) the debtor knowingly and fraudulently, in or in connection with the case--(A) made a false oath or account;

(7) the debtor has committed any act specified in paragraph (2), (3), (4), (5), or (6) of this subsection, on or within one year before the date of

the filing of the petition, or during the case, in connection with another case, under this title or under the Bankruptcy Act, concerning an insider;"

FN3. 11 USC § 523(a)(4) provides: "(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) 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;"

FN4. 11 USC § 523(a)(6) provides: "(a) A discharge under section 727, 1141, 1228(a), 1128(b), or 1328(b) of this title does not discharge an individual debtor from any debt--(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;"

FN1. This calculation does not consider the $128,000.00 Mr. Rudd invested of his own or his daughter's money, nor does it account for any gains and losses he made on his investments.

FN2. There was testimony by Rudd that he delivered paintings to the beneficiaries, but no value was placed on them. We assume they are included in the principal or, at the very least, they are worthless.

FN3. Rudd's accounting indicates he paid $100,000 to the beneficiaries, but his uncontradicted testimony was that he paid $106,000.

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