



contractor, on Defendant/Debtor's property located at Lot 48, Notting Hills West Subdivision, Glynn County, Georgia, and asserts that this obligation is nondischargeable. By virtue of 28 U.S.C. Section 157(b)(2)(I), this matter is a core proceeding. Pursuant to Rule 7052 of the Federal Rules of Bankruptcy Procedure, this Court held a trial on November 11, 1995, and makes the following findings of fact and conclusions of law.

#### FINDINGS OF FACT

On June 21, 1994, Debtor executed a promissory note and Deed to Secure Debt in favor of The Coastal Bank of Georgia, which note and debt deed were in the face amount of \$109,500.00. As part of the same transaction, Debtor bought and pledged to the Coastal Bank, as collateral for the loan, real estate located at Lot 48, Notting Hills West Subdivision. The purchase price of the real estate was \$35,000.00. At that time, this property was an unimproved lot.

The purpose of the loan was to enable Debtor to purchase the lot and construct a house for resale ("spec" house) on the subject lot. The total cost of the construction, including the price of the unimproved real estate, was to be approximately \$146,000 more than the amount of the loan. Apparently because of a lack of resources, Debtor was unable to meet his financial obligations and filed for Chapter 7 protection on April 3, 1995. Plaintiff, a subcontractor of Debtor, brought this action to determine the dischargeability of a debt owed on account of drywall provided for the "spec" house.

On or about August 1, 1994, Debtor contracted orally with Plaintiff, Golden

Isles Drywall, to install and finish the drywall in the house for the sum of \$5,269.60. The work was completed on or about September 1, 1994. The terms of payment for the finished work product are the central issue in this adversary. Plaintiff contends that Debtor agreed to pay for the drywall when he received a draw from Coastal Bank for a progress payment representing the completed drywall installation. Debtor denies that such an arrangement existed between Debtor and Coastal Bank. The dispute is not material because the testimony revealed that upon demand by Plaintiff, after completion of the drywall, Debtor promised to remit to Plaintiff monies owed upon receipt of the next draw from the bank. Contrary to this promise, Debtor admitted using those proceeds not to pay for labor and material for the house but instead to pay employees of his plumbing business, Precision Plumbing.<sup>2</sup> Coastal Bank's loan officer testified that Debtor's loan agreement with Coastal Bank required him to use the loan proceeds towards the completion of the "spec" house although specific subcontractors were not designated as recipients for individual draws.

Plaintiff contends that the debt is nondischargeable pursuant to Section 523(a)(4), on the theory that Debtor either committed (1) fraud or defalcation while acting in a fiduciary capacity or (2) embezzlement. Plaintiff asserts that Georgia law creates a trust as a matter of law on contractors when dealing with subcontractors in O.C.G.A. Section 16-8-15. In the alternative, Plaintiff asserts that Debtor "embezzled" proceeds of the loan which were due to Plaintiff. Specifically, according to Plaintiff, because of the agreement between Coastal

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<sup>2</sup> The evidence reveals that Debtor received a draw of \$5,000.000 on September 9, 1994. The evidence further reveals that Debtor received a draw of \$4,000.00 on September 24, 1994. Plaintiff submitted his bill to Debtor on or about September 15, 1994.

Bank and Debtor, Debtor was entrusted with loan proceeds which he embezzled when he intentionally chose to pay the employees of his plumbing business with the money received from a particular draw rather than pay Plaintiff.

In general, Debtor denies the allegations. Debtor contends that the agreement between Coastal Bank and Debtor only amounts to a routine loan transaction and that O.C.G.A. Section 16-8-15 does not create a trust as a matter of law in favor of subcontractors. Debtor contends that as a general contractor he had absolute title to loan proceeds and, therefore, Debtor could not have embezzled from himself. Debtor also suggests that because the loan was for an amount less than the total projected cost of completion his use of loan proceeds towards payment of Precision Plumbing employees is immaterial.<sup>3</sup>

Both parties have filed motions for Rule 9011 sanctions. Plaintiff asserts that Debtor has misrepresented the law and argued positions contrary to unrebutted evidence. Debtor argues that Plaintiff's lawsuit is completely unfounded.

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#### CONCLUSIONS OF LAW

In pertinent part, 11 U.S.C. Section 523(a)(4) provides,

(a) A discharge under section 727 ... of this title does not discharge an individual debtor from any debt--

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<sup>3</sup> In other words, Debtor argues that it is possible that Plaintiff was to be paid from monies supplied by Debtor. Therefore, Debtor contends that Plaintiff cannot assert a right to draws from which he can not prove that his claim would be satisfied.

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

11 U.S.C. §523(a)(4). Section 523(a)(4) permits a debt to be excepted from discharge for either (1) defalcation while acting in a fiduciary capacity or (2) embezzlement. In general, defalcation while acting as a fiduciary only requires a plaintiff to prove a simple misappropriation; however, in regard to the element of entrustment, it is generally understood that the term "fiduciary" refers only to "technical" trusts and, therefore, a plaintiff must prove the existence of either an express trust or trust as a matter of law. In re Turner, 134 B.R. 646, 650 (Bankr.N.D.Okl. 1991). A mere showing of a constructive or equitable trust is not enough. Under this section, embezzlement has been loosely defined as the fraudulent appropriation of property by person to whom such property has been entrusted, or into whose hands it has lawfully come. *See Savonarola v. Beran*, 79 B.R. 493 (Bankr.N.D.Fla. 1987). To meet the requirements of embezzlement a plaintiff must show only that a defendant was entrusted with property and acted with a fraudulent intent. *See In re Davis*, 115 B.R. 346, 351 (Bankr.N.D.Fla. 1990). The end result is that pursuant to Section 523(a)(4) a plaintiff must prove either a misappropriation of property held in legal trust or the intentional misappropriation of entrusted property.

#### **I. Defalcation While Acting in a Fiduciary Capacity**

To meet its burden under Section 523(a)(4), Plaintiff must prove (1) that a defalcation was committed while (2) acting in a fiduciary capacity. The standard and still widely cited definition of defalcation is that of Judge Learned Hand in Central Hanover Bank

& Trust Co. v. Herbst, 93 F.2d 510 (2nd Cir.1937). Judge Hand concluded that while a purely innocent mistake by a fiduciary may be dischargeable, a "defalcation" does not have to rise to the level of "fraud," "embezzlement," or even "misappropriation." Id. at 512. See Quaif v. Johnson, 4 F.3d 950, 955 (11th Cir.1993). Here, Debtor knowingly paid the money received from his draw to the employees of his plumbing business. Clearly, this action rises to the accepted standard of defalcation.

The main issue of contention in this offense is whether Debtor possessed a fiduciary duty to Plaintiff. I hold that a duty did not exist. When considering the possible existence of a fiduciary relationship, it is necessary to be mindful of the Supreme Court's holding that the term "fiduciary" should not be construed expansively, but instead is intended to refer to "technical" trusts. See Chapman v. Forsyth, 43 U.S. (2 How.) 202, 11 L.Ed. 326 (1844); Upshur v. Briscoe, 138 U.S. 365, 11 S.Ct. 313, 34 L.Ed. 931 (1891); Davis v. Aetna Acceptance Co., 293 U.S. 328, 55 S.Ct. 151, 79 L.Ed. 393 (1934). Trusts recognized under Section 523(a)(4) generally fall into two categories: (1) express trusts<sup>4</sup> and (2) trusts created as a matter of law.<sup>5</sup> In re Turner, 134 B.R. at 650. Federal law restricts the scope of the fiduciary concept to the two above mentioned technical trusts; thereby, excluding implied or constructive trusts.<sup>6</sup> Matter of Angelle, 610 F.2d 1335, 1341 (5th Cir.1980). In addition, as

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<sup>4</sup> Express trusts are created by an agreement between the parties to impose a trust relationship. In re Levitan, 46 B.R. 380, 384 (Bankr.E.D.N.Y. 1985).

<sup>5</sup> Trusts as a matter of law are trusts imposed upon parties by a statute that specifically imposes fiduciary obligations on a party. In re Levitan, 46 B.R. at 384.

<sup>6</sup> A constructive trust "is a remedial device created by a court of equity to prevent unjust enrichment." Lee v. Lee, 260 Ga.

a matter of federal law, each type of technical trust, either express or as a matter of law, must have existed prior to the act which created the debt. Id. at 1341. As a result, state criminal statutes that create a trust upon misappropriation do not satisfy the "fiduciary" requirement, but statutes which impose trustlike duties, such as an obligation to segregate accounts, may make parties into fiduciaries. Id.

In light of the above, it is clear why O.C.G.A. Section 16-8-15, a Georgia criminal statute that punishes the misappropriation of funds by a contractor, does not create a fiduciary duty on contractors. O.C.G.A. Section 16-8-15 only concerns the consequences after a misappropriation occurs. The statute fails to impose trustlike duties on contractors such as the segregation of accounts. In general, O.C.G.A. Section 16-8-15 and other similar criminal statutes will never impose a fiduciary duty or "trust as a matter of law" on general contractors.<sup>7</sup>

## **II. Embezzlement**

Plaintiff also asserts that Debtor committed "embezzlement" under Section

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356(2), 392 S.E.2d 870 (1990). In matters of state law, a constructive trust will be implied if the circumstances are such that the persons "holding legal title to the property, either from fraud or otherwise, cannot enjoy the beneficial interest in the property without violating some established principal of equity." O.C.G.A. § 53-12-93(a).

<sup>7</sup> Note, discussions between the parties such as, "I will pay you from the next draw," do not create an express trust in favor of Plaintiff. These communications and promises occurred after Plaintiff completed the drywall. In other words, promises or guarantees after the creation of a debt only reflect normal exchanges between a debtor and creditor and not the relationship between a trustee and his fiduciary.

523(a)(4). This assertion possesses merit. Embezzlement is defined by federal law. In re Powell, 54 B.R. 123, 125 (Bankr.D.Or. 1983). The Supreme Court has defined embezzlement as "the fraudulent appropriation of property by a person to whom such property has been entrusted or into whose hands it has lawfully come." Moore v. United States, 160 U.S. 268, 269, 16 S.Ct. 294, 295, 40 L.Ed. 422 (1895); *see also* In re Schultz, 46 B.R. 880, 889 (Bankr.D.Nev. 1985)(definition of embezzlement applied in context of Code Section 523(a)(4)). The Ninth Circuit has defined embezzlement pursuant to Section 523(a)(4) as an offense which requires three elements: (1) property rightfully in the possession of a nonowner; (2) nonowner's appropriation of the property to a use other than that to which it was entrusted; and (3) circumstances indicating fraud. In re Littleton, 942 F.2d 551, 555 (9th Cir.1991). The claim is established if it is shown that Debtor, with the requisite fraudulent intent, used the entrusted proceeds for a purpose other than specified in the agreement with Coastal Bank. *See* In re Sutton, 39 B.R. 390, 395 (Bankr.M.D.Tenn. 1984)(in order to prove embezzlement, one must establish "fraud in fact" which involves moral turpitude or intentional wrong); In re Storms, 28 B.R. 761, 765 (Bankr.E.D.N.C. 1983)(plaintiff must establish that the debtor was not lawfully entitled to use the funds for the purposes for which they were in fact used); In re Belfry, 862 F.2d 661, 663 (8th Cir.1989)(plaintiff must show more than an understanding of the purpose of a loan; instead, he must prove that the agreement did not permit full use of the money by debtor). Proof of a fiduciary relationship is not necessary. In re Kelly, 84 B.R. 225, 231 (Bankr.M.D.Fla. 1988). Here, it is uncontradicted that the loan proceeds were to be used only for improvements to the "spec" house. Yet it is also uncontradicted that Debtor intentionally used the money to pay the employees of his plumbing business. Fraudulent appropriation requires an intent to deprive, which can be inferred from the conduct of the

person accused and from the circumstances of the situation. Matter of Shuler, 21 B.R. 643, 644 (Bankr.Id. 1982). Accordingly, in the absence of proof that the payment was a mistake or that Debtor had other resources to pay the debt, I hold that Debtor intended to deprive Plaintiff and the other intended beneficiaries of monies owed when he used the proceeds of the loan agreement to pay the employees of Precision Plumbing. Thus, because Debtor embezzled the funds due to Plaintiff, the debt must be excepted from discharge.<sup>8</sup>

### **III. Damages**

Section 523(a)(4) provides that "a discharge ... of this title does not discharge an individual debtor from any debt for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. § 523(a)(4). Here, Plaintiff showed that \$4,000 advanced for payment of labor and materials in the house was used instead for a purpose outside the scope of the loan agreement. Debtor was unable to rebut Plaintiff's uncontradicted testimony that the \$4,000 draw of September 24, 1994, was intended for Plaintiff on account

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<sup>8</sup> In his brief, Debtor either implicitly or expressly suggests that Plaintiff does not have a cause of action because he is not a party to the contract between Coastal Bank and Debtor. On the contrary, Plaintiff may indeed sue Debtor as he, Plaintiff, is an intended and not incidental beneficiary of the contract. Briefly, an intended beneficiary may maintain a direct action against a promisor, if the beneficiary can prove two elements: (1) a party to a contract, promisor, has undertaken a duty of performance which runs to a third party and (2) a party to the contract, promisee, who bargained with the promisor, intended a beneficiary status to be bestowed upon the third party. See In re Richardson, 179 B.R. 19, 24 (Bankr.D.Dist.Col. 1995) (trust beneficiary may assert nondischargeability rights under § 523(a)(4)). Clearly, Coastal Bank's intent was for Debtor to use the loan proceeds to pay materialmen who might file liens on the property. This Court finds that Debtor was aware of its duty to pay these materialmen and that Plaintiff as a member of this group of intended beneficiaries may maintain this cause of action.

of drywall installation. Balancing Debtor's right for a fresh start with Plaintiff's right to payment of its debt, I find that the evidence demands that Plaintiff's debt be excepted from discharge for embezzlement, but only to the extent of the \$4,000 draw which Debtor misapplied toward the payment of Precision Plumbing employees.

As to the mutual request for sanctions under F.R.B.P. 9011, the underlying legal issues of this case are complex and both counsel persuasively argued their positions within the bounds of reasonable advocacy. Both Plaintiff's and Debtor's Rule 9011 motions are hereby denied.

ORDER

Pursuant to the foregoing Findings of Fact and Conclusions of Law, IT IS THE ORDER OF THIS COURT that Debtor's obligation to Plaintiff in the amount of \$4000.00 is excepted from his discharge.

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Lamar W. Davis, Jr.  
United States Bankruptcy Judge

Dated at Savannah, Georgia

This \_\_\_ day of January, 1996.