United States District Court
Southern District of Texas

Case Number: 04-3618

ATTACHMENT

Description:

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Other: 61- 79

purposes of issue and claim preclusion 'despite the taking of an appeal unless what is called an appeal actually consists of a trial *de novo*.'" *Scurlock Oil Co. v. Smithwick*, 724 S.W.2d 1, 6 (Tex. 1986) (quoting *Restatement (Second) of Judgments* § 13 (1982); overruling *Texas Trunk Ry. Co. v. Jackson*, 85 Tex. 605, 22 S.W. 1030 (1893)). Thus, Texas law now follows the established rule in federal courts "that a final judgment retains all of its res judicata consequences pending decision on appeal." *Id.* In the adversary proceeding at bar, the Judgment is final; the fact that the Debtor did not exercise her appellate remedies prior to her bankruptcy filing does not mean that *res judicata* is inapplicable. This principle is applicable here, and the Debtor may not argue otherwise.

Notwithstanding that the Judgment is final and valid, the newly raised matter before this Court is the issue of dischargeability of this debt. Since 1970, the issue of dischargeability has been a matter of federal law governed by the Bankruptcy Code and to be decided by the bankruptcy court. *Brown v. Felsen*, 442 U.S. 127, 129 – 130, 138 (1979). Nondischargeability is "independent of the issue of the validity of the underlying claim." *Grogan v. Garner*, 498 U.S. at 289. In the proceeding at bar, not only was dischargeability not decided at the state level, it could not have been decided. The Fifth Circuit has pointed out that "Congress intended to give the bankruptcy court exclusive jurisdiction to determine bankruptcy dischargeability issues." *In re Shuler*, 722 F.2d 1253, 1254 (5th Cir. 1984). In fact, in *Brown v. Felson*, the United States Supreme Court held that the creditor "does not assert a new ground for recovery . . . Rather, what he is attempting to meet here is the new defense of bankruptcy which respondent [the debtor] has interposed between petitioner [the creditor] and the sum determined to be due him." 442 U.S. at 133. The Supreme Court further said that with respect to deceit, fraud and malicious conversion, "these questions are now, for the first time, squarely in issue. . .[t]hey are the type of questions Congress intended that the bankruptcy court would resolve." *Id.* at 138.

Consequently, the Fifth Circuit has held that in determining dischargeability where a state court judgment evidencing a debt has been rendered, a bankruptcy court is not bound by such judgment and, therefore, res judicata does not bar the court from receiving evidence by which it can discern the character of and, hence, the dischargeability of the debt. *In re Shuler*, 722 F.2d at 1255 (citing *Carey Lumber v. Bell*, 615 F.2d 370, 377 (5th Cir. 1980)). The United States Supreme Court has clarified that collateral estoppel may apply in § 523(a) discharge exception proceedings. *Grogan v. Garner*, 498 U.S. at 284, n. 11. However, the converse is also true: subsidiary facts necessary to determining dischargeability "that have not been actually and necessarily litigated or that are not discernible from the record, must also be determined by it [the bankruptcy court] after hearing all relevant evidence . . . ." *In re Shuler*, 722 F.2d at 1256, (citing *Franks v. Thomason*, 4 B.R. at 814, 820-21 (Bankr. N.D. Ga. 1980); *see also In re Poston*, 735 F.2d 866, 869 (5th Cir. 1984) (bankruptcy court properly found that the record did not contain sufficient facts to support the conclusory recitals in the state court judgment).

The rule in the Fifth Circuit is that "an issue is 'actually litigated' only when it is properly raised by the pleadings, submitted for a determination, and actually determined." *In re Gober*, 100 F.3d at 1203 (citing *In re Garner*, 56 F.3d 677, 680 (5th Cir. 1995)). In the adversary proceeding at bar, Rainey filed the 2001 Lawsuit requesting judgment against the Debtor for breach of contract for failure to make payments to him under the Mediation Settlement Agreement and the related promissory note. [FOF No. 58]. The Debtor filed a general denial, various motions, and her First

Amended Original Answer, and she alleged some affirmative defenses, but she did not appear at the March 7, 2003, trial [FOF Nos. 59, 62, 63, 65, 67, 68, 72 and 73]; consequently, the Judgment was rendered solely on Rainey's Motion for Summary Judgment [FOF No. 73]. Since Rainey did not raise the issue of the underlying character of the debt in the 2001 Lawsuit, the nature of the Debtor's actions with respect to the debt were not submitted for determination by that state court and, hence, were not decided. Therefore, this Court appropriately held a trial to receive evidence to determine facts sufficient to discern whether Rainey's claim is nondischargeable under 11 U.S.C. § 523(a).

D. Novation and Underlying Character of Rainey's Claim

The Debtor argues that because Rainey seeks to enforce the amount of a money judgment, he is bound by the character of that same judgment. Her argument hinges upon the idea that regardless of the behavior that gave rise to the debt, once the debt was settled by way of mediation, the debt took on the character of the contract which resulted from the settlement. In short, the Debtor argues that the debt underwent a form of novation so that after settlement, the debt lost its antecedents and became purely a contractual matter. Thus, the Debtor contends, the 2001 Lawsuit became merely an action for breach of contract; the Judgment was rendered on such breach; and this Court is now barred from looking behind the Judgment to inquire into the original nature of the debt. [Defendant Debtor's Response to Plaintiff's Motion for Summary Judgment and Response to Motion for Sanctions at pages 17 - 18]. The Debtor has misread the law.

Twenty-six years ago the United States Supreme Court addressed this very issue under §

17a(2) and (4) of the Bankruptcy Act of 1898[42], the predecessor to current Bankruptcy Code § 523(a)(4) and (a)(6) with which this adversary proceeding is concerned. With respect to a debt allegedly incurred by fraud and later settled by stipulation, the Supreme Court held that the bankruptcy court is not limited to reviewing the underlying state court judgment and record but should look behind the stipulation to determine whether the creditor had a valid claim for fraud. *Brown v. Felsen*, 442 U.S. at 138–139. By inquiring into the legislative history of Bankruptcy Act § 17, the Supreme Court was able to elucidate Congress' intent "that all debts arising out of conduct specified in §17 should be excepted from discharge and the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt." *Id.* at 138.

In 2003, the Supreme Court once again addressed this issue; this time, under Bankruptcy Code § 523(a). In a case similar to the one at bar, the Supreme Court reaffirmed its holding in *Brown* and held that a debt embodied in the settlement of a fraud case arises out of the underlying fraud. *Archer v. Warner*, 538 U.S. 314, 321 (2003). The Supreme Court concluded that the settlement agreement may have worked a type of novation but that such circumstances would not bar the claimants from showing that the settlement debt arose out of conduct blocking discharge under § 523(a). *Id.* at 323.

The Debtor, aware of the holdings in *Brown* and *Archer*, nonetheless argues, as discussed

[42] § 17a of the Bankruptcy Act of 1898 provided for the types of debts not dischargeable in bankruptcy. These were substantially similar to those under Bankruptcy Code § 523(a) and included under § 17a(2) "liabilities for obtaining money or property by false pretenses or false representations . . . or for willful and malicious conversion of the property of another." § 17a(4) included debts that "were created by . . . [the debtor's] fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity." *See Brown v. Felson*, 442 U.S. 127, 129 including n.1 (1979).

above, that the intervening Mediation Settlement Agreement should preclude this Court from considering the original character of Rainey's claim. In so doing, the Debtor relies solely on the dissent in *Archer* and her sense that the majority's opinion produces an unfair result.[43] Her position cannot stand. The United States Supreme Court's decisions, first in *Brown* and then in *Archer,* make it incumbent upon this Court to inquire into the nature of the actions of the parties out of which Rainey's claim arose; and this, the Court has done.

E. Sections 523(a)(4) and (6) of the Bankruptcy Code

A Chapter 7 discharge under Bankruptcy Code § 727 does not discharge an individual debtor from any debt for fraud or defalcation while acting in a fiduciary capacity, for embezzlement, or for larceny; or for willful and malicious injury by the debtor to another entity. 11 U.S.C. § 523(a)(4) and (6). Rainey alleges that his claim against the Debtor falls within either or both of these sections; the Debtor vehemently disagrees.

1. Did the Debtor commit fraud or defalcation while acting in a fiduciary capacity?

The United States Supreme Court long ago stated that the general purpose of bankruptcy law is to give "the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt." *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (citations omitted); *accord Lines v. Frederick*, 400 U.S. 18, 19 (1970), *In re Angelle*, 610 F.2d 1335, 1339 (5th Cir. 1980). To facilitate this general policy of

[43] The Debtor references *Archer* in her Response to Rainey's Motion for Summary Judgment, argues against the majority holding, and espouses the dissent's position.

allowing the debtor to make a fresh start[44], it is "a well-established principle that exceptions to discharge should be limited to those clearly expressed in the statute." *In re Angelle*, 610 F.2d at 1339 (citing *Gleason v. Thaw*, 236 U.S. 558, 562 (1915)). Although originally written with respect to the Bankruptcy Act of 1898, the Fifth Circuit has expressly applied these principles to the Bankruptcy Code. *In re Boyle*, 819 F.2d 583, 588-589 (5th Cir. 1987). As a result, the Fifth Circuit has found that the plain language of § 523(a)(4) and a reading of the limited record of congressional intent indicate that the discharge exceptions thereunder only apply to "debts incurred through abuses of fiduciary positions and through active misconduct whereby a debtor has deprived others of their property by criminal acts." *Id.* at 587–588; *accord In re Miller*, 156 F.3d at 602. In other words, by way of fraud or a crime.

The phrasing of § 523(a)(4) makes it clear that for a debt to be nondischargeable due to fraud or defalcation, the debtor must have owed the claimant a fiduciary duty. Between 1844[45] and 1934, the United States Supreme Court addressed and refined the concept of a fiduciary with respect to nondischargeability of debts. The concept of a fiduciary is to be narrowly construed so that the duty must arise out of a technical trust and not from a relationship which the law implies from the related contract. *Chapman v. Forsyth*, 43 U.S. 202, 207 (1844). In addition, such technical trust and resultant fiduciary duty must exist prior to the creation of the debt and without reference to the debt. *Upshur v. Briscoe*, 138 U.S. 365, 378 (1891); *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333

[44] *In re Boyle*, 819 F.2d 583, 588 (5th Cir. 1987).

[45] The Bankruptcy Act of 1841 contained a provision similar to § 17a(4) of the Bankruptcy Act of 1898, which itself is similar to § 523(a)(4). *In re Angelle*, 610 F.2d at 1338.

(1934).

The Fifth Circuit has explained that a technical trust is also called an express trust and that "a constructive trust is not sufficient to create a fiduciary relationship for purposes of the discharge provisions of the Bankruptcy Act." *In re Bennett*, 989 F.2d 779, 784 (5th Cir. 1993) (citing *Chapman v. Forsyth*, 43 U.S. at 207; *In re Angelle*, 610 F.2d at 1335). Further, following *Upsher*, the express trust must have been in existence prior to any wrong doing and "[t]he debtor must have been a trustee before the wrong and without any reference to it." *Id.* at 784 (citing *Upshur v. Briscoe,* 138 U.S. at 378; *Ragsdale v. Haller*, 780 F.2d 794, 796 (9th Cir. 1986)).

Although the concept of fiduciary under § 523(a)(4) is a question of federal law, "state law is important in determining whether or not a trust obligation exists." *Id.*, citing *In re Angelle*, 610 F.2d at 1339. Today, most courts recognize that an express trust can arise not only via a formal trust agreement but also through obligations imposed by statute or common law. *Id.*, at 785. For example, an officer of a corporation owes a common law fiduciary duty to both the corporation and stockholders. *Id.* (citing *Moreno v. Ashworth*, 892 F.2d 417, 421 (5th Cir. 1990)). Or, by way of another example, the Oklahoma Lien Trust statutes create an express trust which gives rise to a fiduciary duty under § 523(a)(4). *Id.* at 785 (citing *Carey Lumber Co. v. Bell*, 615 F.2d 370, 374 (5th Cir. 1980).

Thus, the seminal question with respect to fraud or defalcation is: under Texas law involving express trusts, did the debtor owe the claimant a preexisting fiduciary duty? In the proceeding at bar, was the Debtor a trustee with respect to Rainey at the time of their original oral agreement? If the answer is in the negative, then it is of no moment if the Debtor's actions constituted fraud or defalcation.

In Texas, "[f]iduciary duties arise as a matter of law in certain formal relationships, including attorney-client, partnership, and trustee relationships." *Ins. Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex. 1998) (citations omitted). Clearly, the Debtor and Rainey did not share an attorney-client relationship. Nor did the Debtor stand in a formal trustee relationship with Rainey.

Neither a partnership nor a joint venture is established solely by an agreement to share net fees such as that which existed between the Debtor and Rainey. *Ben Fitzgerald Realty Co. v. Muller*, 846 S.W.2d 110, 120 (Tex. App. – Tyler 1993, writ denied). Instead, both a partnership and a joint venture require the same four essential elements, with a joint venture usually being limited to one particular enterprise. *Id.* (citing *State v. Houston Lighting & Power Co.*, 609 S.W.2d 263 (Tex. Civ. App. – Corpus Christi 1980, writ ref'd n.r.e.); *N. Tex. Lumber Co. v, Kerpar*, 415 S.W.2d 470 (Tex. Civ. App. - Dallas 1967, writ ref'd n.r.e.)). These four elements are: (1) a community of interest in the venture; (2) an agreement to share profits; (3) an agreement to share losses; and (4) a mutual right of control or management of the enterprise. *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 176 (Tex. 1997) (citing *Coastal Plains Dev. Corp. v. Micrea, Inc.*, 572 S.W.2d 285, 287 (Tex. 1978)). The Debtor and Rainey had a community of interest in the Brio/DOP Litigation insofar as they were to split net fees in an 85%/15% ratio. [FOF Nos. 7 and 20]. However, the Agreement did not provide for Rainey to share in any losses, nor was there any evidence introduced indicating that Rainey had any right to control or manage the enterprise, i.e., the Brio/DOP Litigation. In fact, the Debtor precluded Rainey from being involved in discussions with O'Quinn and Williams regarding their respective deductions from the fees owed to the Davenport Law Firm [FOF Nos. 15 and 30]; and Rainey was unable to obtain an accounting of receipts from the Debtor [FOF Nos. 15 and 30]. Consequently, this Court finds that there was neither an express nor implied partnership or joint venture between the Debtor and Rainey. *See id.* Therefore, no partnership was created between the Debtor and Rainey; and, accordingly, no fiduciary relationship existed between these two persons.

The Texas Supreme Court has also recognized informal fiduciary relationships. However, "not every relationship involving a high degree of trust and confidence rises to the stature of a fiduciary relationship." *Id.* at 176-77 (citing *Crim Truck & Trailer Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 594 (Tex. 1992)). Further, such relationship must exist before, and independent of, the agreement out of which the controversy arose. It is also important to note that "mere subjective trust [by one party on another] does not, as a matter of law, transform arm's-length dealing into a fiduciary relationship." *Id.* Therefore, any fiduciary relationship that could possibly have existed between the Debtor and Rainey could not have arisen out of the Agreement. In addition, it is highly likely that under the narrower federal common law defining a fiduciary under § 523(a)(4), an informal fiduciary relationship would not rise to the level of an express trust. *See In re Miller*, 156 F.3d at 602.

The Debtor's original and ongoing relationship with Rainey was that of an employer to employee. [FOF No. 8]. A fiduciary relationship is one that requires good faith and fair dealing. *See Banner Life Ins. Co. v. Pacheco*, 154 S.W.3d 822, 831 (Tex. App. – Houston [14th Dist.] 2005, no. pet. h.). However, the Texas Supreme Court has "decline[d] to impose a duty of good faith and fair dealing on employers." *City of Midland v. O'Bryant*, 18 S.W.3d 209, 216 (Tex. 2000). As a result, the overarching relationship between the Debtor and Rainey, as employer and employee, did not impose a fiduciary duty on her.

Nonetheless, Rainey argues that Texas Disciplinary Rule of Professional Conduct (the Disciplinary Rules) 1.14 required the Debtor to safeguard and maintain in a separate account funds received on his behalf from the Brio/DOP Litigation. Disciplinary Rule 1.14 provides in pertinent part:

> (a) A lawyer shall hold funds and other property belonging in whole or in part to clients or third persons that are in a lawyer's possession *in connection with a representation* separate from the lawyer's own property. Such funds shall be kept in a separate account . . . .
>
> (b) Upon receiving funds or other property in which a client or third person has an interest, a lawyer shall promptly notify the client or third person. . . . a lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request by the client or third person, shall promptly render a full accounting regarding such property.
>
> (c) *When in the course of representation* a lawyer is in possession of funds or other property in which both the lawyer and other person claim interests, the property shall be kept separate by the lawyer until there is an accounting and severance of their interest. . .

TEX. DISCIPLINARY R. PROF'L CONDUCT 1.14, *reprinted in* TEX. GOVT. CODE ANN., tit. 2, Subt. G app. A, Art. 10, § 9, Rule 1.14 (Vernon 2005) (TEX. STATE BAR R. art. X, § 9) (emphasis added).

This Rule and its attendant comments are located in the client-lawyer section of the Disciplinary Rules and, consequently, relate primarily to a lawyer's relationship with her clients. Comment 3 to Disciplinary Rule 1.14 provides that "[t]hird parties, such as client's creditors, may have just claims against funds or other property in a lawyer's custody." TEX. DISCIPLINARY R. PROF'L CONDUCT 1.14 cmt. 3. To the extent that this rule relates to non-clients, Comment 3 implies that funds are to be held in trust for those persons with claims on the client's money. This interpretation is supported by the modest case law related to this particular Disciplinary Rule. *See, e.g., Butler v. Comm'n for Lawyer Discipline*, 928 S.W.2d 659 (Tex. App. – Corpus Christi 1996) (holding that an attorney violated Disciplinary Rule 1.14 by not maintaining workers' compensation settlement funds in a separate account until his client's other attorney was paid or the dispute resolved); *State of Oklahoma, ex rel. Okla. Bar Ass'n. v. Taylor*, 71 P.3d 18 (Okla. 2003) (finding that an attorney violated Oklahoma Rule of Professional Conduct 1.15 [equivalent to Texas Disciplinary Rule 1.14] by disbursing disputed client settlement funds to himself, client's other attorney and medical providers). In both of these cases, the client's "other attorney" provided services separate and apart from the attorney in control of the settlement funds. Thus, it was the client, not the attorney in control, who owed a fee to the "other attorney." Conversely, in this proceeding, the Debtor, not a client, directly owes Rainey his proportionate share of the fees as compensation for services rendered as her employee.

Related Comment 4 provides that:

> The obligations of a lawyer under this Rule are independent of those arising from activity other than rendering legal service. For example, a lawyer who serves as an escrow agent is governed by the applicable law relating to fiduciaries even though the lawyer does not render legal services in the transaction.

Tex. Disciplinary R. Prof'l Conduct 1.14 cmt.4.

This Comment indicates that the nature of a lawyer's obligation is governed by the underlying nature of the transaction. In this instance, the Debtor received the funds as fees for work done by her firm on the Brio/DOP Litigation. [FOF Nos. 15, 26, 29 and 45]. Her obligation to Rainey was that of an employer to an employee of her law firm. [FOF No. 8]. Consequently, the Debtor only owed Rainey the duty to pay him his contractually agreed share of the fees as compensation. As an employer, the Debtor did not owe Rainey any fiduciary duty with respect to those fees.

Finally, even if Disciplinary Rule 1.14 could be otherwise found to impose a fiduciary duty on the Debtor with respect to monies received from the Brio/DOP Litigation and due to be paid to Rainey, Paragraph 15 to the Preamble to the Disciplinary Rules makes it quite clear that the Disciplinary Rules are not to be used as the basis for a private cause of action. Paragraph 15 reads, in pertinent part, as follows:

> 15. These rules do not undertake to define standards of civil liability of lawyers for professional conduct. *Violation of a rule does not give rise to a private cause of action . . . .* Likewise, these rules are not designed to be standards for procedural decisions. Furthermore, the purpose of these rules can be abused when they are invoked by opposing parties as procedural weapons. The fact that a rule is a just basis for a lawyer's self-assessment, or for sanctioning a lawyer under the administration of a disciplinary authority, does not imply that an antagonist in a collateral proceeding or transaction has standing to seek enforcement of the rule. Accordingly, *nothing in the rules should be deemed to augment any substantive legal duty of lawyers* or the extra-disciplinary consequences of violating such a duty.

TEX. DISCIPLINARY R. PROF'L CONDUCT preamble ¶ 15 (emphasis added).

The highlighted language indicates that if the Debtor does not independently owe Rainey a fiduciary duty, the Disciplinary Rules do not impose such a duty upon her. *See Judwin Props., Inc. v. Griggs & Harrison, P.C.*, 981 S.W.2d 868, 870 (Tex. App. – Houston [lst Dist.] 1998, pet. denied). If Rainey believes that the Debtor has violated Disciplinary Rule 1.14, his recourse is to file a grievance against her.

This Court is cognizant of the fact that the Debtor owed Rainey a contractual obligation to pay him the agreed upon portion of the Brio/DOP fees. That she did not do so when she had the monies in hand, at best, speaks poorly of her judgment. Nonetheless, after carefully scrutinizing the law, it is clear that the Debtor did not owe Rainey a fiduciary duty with respect to such funds and, therefore, it is irrelevant whether her actions constituted fraud or defalcation. Hence, that portion of Bankruptcy Code § 523(a)(4) does not prevent the discharge of Rainey's claim against the Debtor.

2. Did the Debtor commit larceny or embezzlement?

The Bankruptcy Code specifically provides for the nondischargeability of any debt incurred by embezzlement or larceny. 11 U.S.C. § 523(a)(4). Unlike fraud and defalcation, if the debt is incurred by commission of either embezzlement or larceny, the debtor need not have been acting in a fiduciary capacity. *In re Boyle*, 819 F.2d 583, 587, n. 9 (5th Cir. 1987); *see also In re Miller*, 156 F.3d 598, 602 (5th Cir. 1998); *In re Littleton*, 942 F.2d 551, 555 (9th Cir. 1991).

For purposes of § 523(a)(4), federal law controls the meaning of larceny and embezzlement. *In re Hayden*, 248 B.R. 519, 525 (Bankr. N.D. Tex. 2000); *In re Brady*, 101 F.3d 1165,1172-73 (6th Cir. 1996); *In re Littleton*, 942 F.2d at 555. Both larceny and embezzlement involve the fraudulent appropriation of another's property; they differ only in timing. Larceny applies when a debtor unlawfully appropriates property at the outset, whereas embezzlement applies when a debtor unlawfully appropriates property after it has been entrusted to the Debtor's care. *See In re Miller*, 156 F.3d at 602; *In re Patton*, 129 B.R. 113, 117 (Bankr. W.D. Tex. 1991). In the proceeding at bar, since the Debtor lawfully came into possession of the fees from the Brio/DOP Litigation, the Debtor could not have committed larceny as a matter of law. Therefore, Rainey's claim cannot be nondischargeable under a larceny theory.

Is the claim nondischargeable under an embezzlement theory? In 1895, the United States Supreme Court 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 (1895). This exact phrase has been adopted by numerous courts with respect to § 523(a)(4), including the Fifth Circuit. *In re Miller*, 156 F.3d at 602. Given that a debtor has lawful control of the property, embezzlement then requires three elements: (1) appropriation of funds by the debtor; (2) for the debtor's use or benefit; and (3) with fraudulent intent. *See e.g., In re Hayden*, 248 B.R. at 525; *In re Patton*, 129 B.R. at116; *In re Beckett*, 96 B.R. 366, 368 (Bankr. M.D. Fla. 1989); *In re Harrell*, 94 B.R. 86, 91 (Bankr. W.D. Tex. 1988); *In re Koelfgen*, 87 B.R. 993, 997 (Bankr. D. Minn. 1988). *See also In re Miller*, 156 F.3d at 602-03.

To "appropriate" is to exercise control over or take possession of property. *In re Hayden*, 248 B.R. at 525 (citing *Black's Law Dictionary* 98 (7th ed. 1999)). There is no question that the Debtor exercised complete control over fees her law firm received from the Brio/DOP Litigation. [FOF Nos. 15, 17, 26, 29 and 31]. There is also no question that some portion of such fees belonged to Rainey, i.e. fifteen percent of the fees after expenses directly related to those discrete suits comprising the Brio/DOP Litigation where (a) net fees were paid to the Davenport Law Firm, and (b) Rainey worked on the suit. [Admission No. 5; Transcript D1, p. 16, lines 23 - 25; and FOF Nos. 20, 39, 85, and 86]. All checks were made payable to the Debtor's law firm and were deposited into her law firm's operating account. [FOF Nos. 26, 29 and 45]. Except for the monies which she paid Rainey—which was insufficient under the Agreement—the Debtor expended all monies for her own purposes either as general operating expenses of her law firm or for her personal use. [FOF Nos. 15, 38 and 39]. The $157,620.82 which the Debtor failed to pay Rainey is the amount that she appropriated for her own use. [FOF No. 94]. For these reasons, the first and second elements establishing embezzlement are satisfied.

The remaining question is whether the Debtor appropriated this $157,620.80 for her own use with fraudulent intent? An intent to defraud can be said to be an intent to deceive another person and thereby induce such other person to transfer, alter or terminate a right with respect to property. *In re Harrell*, 94 B.R. at 91; (citing *In re Brinsfield*, 78 B.R. 364, 370 (Bankr. M.D. Ga. 1987)). Fraudulent intent may be proved by circumstantial evidence. *In re Brady*, 101 F.3d 1165, 1173 (6th Cir. 1996); *In re Buhay*, 77 B.R. 561, 565 (Bankr. W.D. Tex. 1987) (citing *United States v. Powell*, 413 F.2d 1037, 1038 (4th Cir. 1969)); *see also Roberts v. United States*, 151 F.2d 664, 665 (5th Cir. 1945). Since fraud thrives in the shadows, a debtor who acts openly, without any attempt at concealment, and whose actions can be clearly seen, can negate fraudulent intent. *In re Harrell*, 94 B.R. at 91 (citing *In re Myers*, 52 B.R. 901, 905 (Bankr. E.D. Va. 1985)); *see also In re Stern*, 231 B.R. 25, 26 (Bankr. S.D. N.Y. 1999) (affirming the Bankruptcy Court's finding of larceny where the debtor's actions were "done surreptitiously, without the knowledge and without the consent of" the creditor).

The Honorable Larry E. Kelly, Chief Judge for the United States Bankruptcy Court for the Western District of Texas, has found embezzlement where the debtor was aware that the creditors wanted their funds to be returned and the debtor expended such funds without accounting for them. *In re Buhay*, 77 B.R. at 565. Following Judge Kelly's reasoning, The Honorable Robert C. McGuire, the former Chief Judge of the United States Bankruptcy Court for the Northern District of Texas, elucidated, and on appeal, The Honorable United States District Judge Sam A. Lindsay blessed a four-part test for determining fraudulent intent: (1) whether the debtor alone had access to the creditor's money; (2) whether the debtor had knowledge that the creditor wanted his money returned; (3) whether the debtor had accounted to the creditor for the funds; and (4) whether an accounting had been made for the funds. *Pool v. Johnson*, No. 3:01-CV-1168L, 2002 U.S. Dist. LEXIS 6613 (N.D. Tex. April 15, 2002).

Applying this objective test to the Debtor's actions, the conclusion is inescapable that the Debtor acted with fraudulent intent. Settlement fees from the Brio/DOP Litigation were paid directly to the Debtor or her law firm, and she deposited them into her law firm's operating account.[46] [FOF Nos. 26, 29]. The Debtor's testimony was that she did so because "[i]t was just my fees." [FOF No. 29]. Once the funds were in the operating account, the Debtor used the money as she saw fit for law

[46]The Debtor and her sister had access to this account; Rainey did not. [Transcript D5, p. 16, lines 9 - 12].

firm expenses, personal expenses and, at times, to pay Rainey. [FOF Nos. 15, 26, 29, 38 and 39]. Yet, the Debtor has made the judicial admission that even as she used these monies for other purposes, she knew that Rainey had a legal interest in them. [FOF No. 39].

Moreover, while she was disbursing the settlement fees to herself, the Debtor was aware that Rainey wanted his share of the Brio/DOP Litigation fees paid to him. Certainly, in 1996, by the time the Debtor wrote her August 14 letter and received Rainey's September 20 response, the Debtor knew that Rainey wanted and expected the Debtor to pay him all fees that she had promised him. [FOF Nos. 17, 18 and 19]. Regardless, the Debtor did not pay Rainey any money related to the November 1996 check in settlement of the O'Quinn/Brio Litigation. [FOF Nos. 15, 16 and 17]. Later, in September 1997, when the Williams/Brio Litigation settled, Williams calculated that the Davenport Law Firm's share of the fee was over $4.5 million. [FOF No. 25]. However, the Debtor paid Rainey a total of $400,000.00 in three payments during September 1997 and thereafter made it clear to him that she would not be paying him any more money. [FOF Nos. 26, 28, 31 and 40].

As to the third and fourth tests, the Debtor did not account to Rainey for the funds her firm actually received, and should have received, from O'Quinn and Williams; nor has she ever provided Rainey or this Court with an accurate and complete accounting of how the funds her firm did receive were spent. [FOF Nos. 15, 30, and 42]. Indeed, it is this failure to account for the gross settlement receipts and the directly related expenses which most clearly indicate the Debtor's fraudulent intent. A debtor with open and clear intentions would not need to hide behind vague, general statements about high, unexpected expenses. Instead, she would merely account for receipts, directly related expenses, and then payments.

As to the Debtor's explanation of her use of fees for purposes other than to pay Rainey, the

Debtor alleges that she needed the funds to pay ongoing overhead expenses at her law firm. [FOF No. 40]. The Debtor's failure to pay Rainey the specific, identifiable funds so that she could use such funds for general business needs does not preclude a finding of embezzlement. *See In re Taylor*, 58 B.R. 849, 855-856 (Bankr. E.D. Va. 1986); *In re Shuler*, 21 B.R. 643, 644 (Bankr. D. Idaho 1982);. In fact, the transfer of the risk of loss from herself to Rainey highlights the Debtor's embezzlement. *See In re Taylor*, 58 B.R. at 856.

The Debtor has not provided this Court with an adequate explanation of why she did not pay Rainey his fees when she had the means to do so. Under the facts in the proceeding at bar, it is clear that in not paying Rainey, the Debtor embezzled funds rightly belonging to Rainey under § 523(a)(4). Consequently, Rainey's claim is not dischargeable under § 523(a)(4).

3. Did the Debtor commit willful and malicious injury to Rainey?

Alternatively and cumulatively, Rainey argues that his claim is not dischargeable under Bankruptcy Code § 523(a)(6), which provides that a debtor may not be discharged from any debt "for willful and malicious injury by the debtor to another entity or to the property of another entity."[47] In 1998, the United States Supreme Court held that in (a)(6), the word "willful" modifies the word "injury" and thereby causes dischargeability to require a "deliberate or intentional *injury*, not merely a deliberate or intentional *act* that leads to injury." *Kawaauhau v. Geiger*, 523 U.S. 57, 61 (1998) (emphasis in original). This is akin to an intentional tort whereby the actor must intend the consequences of the act and not simply the act itself. *Id.* at 61-62 (citing Restatement (Second) of Torts § 8A, cmt. a (1964)).

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[47] 11 U.S.C. § 101(15) defines "entity" to include a person. Because Rainey is a person, he fits within the term "entity" as that term is used under 11 U.S.C. § 523(a)(6).

Following *Kawaauhau*, the Fifth Circuit has determined that the test for "willful and malicious" should be a single inquiry entailing a two-pronged test. *Miller*, 156 F.3d at 603. That is, " willful and malicious" injury occurs where there is either: (1) an objective substantial certainty of harm; or (2) a subjective motive to cause harm. *Id.* at 606. Under the subjective test, the court would need to find that "the debtor must have intended the actual injury that resulted." *Texas v. Walker*, 142 F.3d 813, 823 (5th Cir. 1998) (citing *In re Delaney*, 97 F.3d 800, 802 (5th Cir. 1996)). As the Fifth Circuit has so pointedly noted, debtors generally deny an intent to cause harm.[48] *In re Red*, No. 03-50642, 2004 U.S. App. LEXIS 8625 (5th Cir. May 3, 2004). Consequently, most decisions which do find willful and malicious injury find debts to be nondischargeable under the objective standard. *Id.* The objective standard is met when the court holds that the debtor "intentionally took action that necessarily caused, or was substantially certain to cause, the injury." *In re Williams*, 337 F.3d 504, 509 (5th Cir. 2003) (quoting *Walker*, 142 F.3d at 823 and *Delaney*, 97 F.3d at 802).

It was the Debtor's failure to pay to Rainey all of his proportionate share of fees received from the Brio/DOP Litigation that gave rise to Rainey's claim. Rainey argues that it was this conduct which was willful and malicious under § 523(a)(6). Certainly, the Debtor's non-payment was egregious. In fact, as discussed *infra*, these acts constitute embezzlement. Yet, the Fifth Circuit has specifically found that under § 523(a)(6), actions which constituted embezzlement *per se* still need to be analyzed to determine the Debtor's intent or whether there had been an objective

[48] The Debtor did so at trial. [Transcript D3, p. 6, line 11 through p. 7, line 18; Transcript D3, p. 203, lines 6 - 9; Transcript D3, p. 209, lines 14 - 15; Transcript D6, p. 267, line 20 through p. 26, line 3; Transcript D6, p. 280, lines 23 - 24].

substantial certainty of harm. *Miller*, 156 F.3d at 606.[49] Likewise, although the Debtor's non-payment can also be classified as the tort of conversion,[50] that alone is not enough to bring the actions under § 523(a)(6). In analyzing § 523(a)(6), the Fifth Circuit cautions that "[m]erely because a tort is classified as intentional does not mean that any injury caused by the tort feasor is willful." *Miller*, 156 F.3d at 604. Similarly, the United States Supreme Court has noted that a knowing breach of contract does not necessarily result in intentional injury. *Kawaauhau*, 523 U.S. at 62. Instead, whether viewing the Debtor's actions as a breach of contract, an embezzlement (a crime), or a conversion (a tort), the dischargeability of her debt to Rainey depends upon the intentional or certain nature of her actions.

It is manifest from the record that the Debtor failed to pay Rainey not because she did not actually receive funds from the Brio/DOP Litigation, but because she used such monies for other purposes. The Debtor testified that although some uses included law firm expenses directly related to the Brio/DOP Litigation, some of the monies were used for general on-going law firm expenses. [FOF No. 38]. Indeed, the Debtor further testified that she would deposit fees from the Brio/DOP Litigation into the law firm's operating account [FOF No. 29], out of which she would pay not only firm expenses but also personal expenses, including her mortgage and automobile payments. [FOF Nos. 38 and 39]. Although Rainey repeatedly asked the Debtor for an accounting of fees received

[49] Although the Fifth Circuit made this finding with respect to embezzlement in 1998, the court crystalized the point with respect to larceny in 2003. *In re Williams*, 337 F.3d 504, 510 (5th Cir. 2003).

[50] Conversion occurs upon the unauthorized and wrongful assumption and exercise of dominion and control over the personal property of another person to the exclusion of, or inconsistent with, the owner's rights. *Waisath v. Lack's Stores, Inc.*, 474 S.W.2d 444, 447 (Tex. 1971); *W.E. Stephens Mfg. Co. v. Goldberg*, No. 08-04-00232-CV, 2005 Tex. App. LEXIS 7039 (Tex. App. – El Paso, Aug. 25, 2005 pet .filed). When the Debtor received monies from the Brio/DOP Litigation and used some of Rainey's portion for her own purposes, she was exercising control over his property inconsistent with his rights and excluding him from so using such property; that is, she "converted" his property.