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# STRATEGIES IN BANKRUPTCY COURT FOR SEEKING THE NONDISCHARGEABILITY OF THE INDEMNITY OBLIGATION DUE TO THE UNAUTHORIZED DIVERSION OF CONTRACT PROCEEDS

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# STRATEGIES IN BANKRUPTCY COURT FOR SEEKING THE NONDISCHARGEABILITY OF THE INDEMNITY OBLIGATION DUE TO THE UNAUTHORIZED DIVERSION OF CONTRACT PROCEEDS

## Introduction

The indemnity rights afforded to a surety by a General Indemnity Agreement are vulnerable to the protections afforded a debtor by a bankruptcy proceeding, particularly where an indemnity agreement has not been perfected under Article Nine of the Uniform Commercial Code more than ninety days prior to a bankruptcy filing. Where a surety's claim against its principal's bankruptcy estate is that of an unsecured creditor, it is not uncommon for the debt to be largely or totally unsatisfied. The hazards of the bankruptcy process are particularly pronounced since the filing of a Chapter 7 or Chapter 11 petition by the principal may be followed by Chapter 7 filings by one or more of the individual indemnitors.

When faced with actual or threatened bankruptcy filings by the principal and the individual indemnitors, it is important for the surety to consider whether any portion of the indemnity obligation may be susceptible to a finding of nondischargeability; that is, whether the debt created by the indemnity agreement can survive the bankruptcy process.

The debts of corporations which file Chapter 7 petitions are not subject to discharge but this is of little consequence since

the corporate entity that survives Chapter 7 is an empty shell--devoid of assets, with no reasonable likelihood of engaging in commerce or being infused with assets at any future time.[1]

Where a reorganization plan is confirmed for a corporate principal who files a Chapter 11 petition, virtually all debts are generally discharged with the exception of those debts specifically addressed by the reorganization plan.[2] The exceptions to the discharge of corporate debts are largely limited to situations where the Chapter 11 Plan causes the liquidation of the company and essentially replicates the results of a liquidation under Chapter 7.[3]

An evaluation of "nondischargeability options" is of much greater significance where a bankruptcy filing by the corporate principal is followed by a Chapter 7 filing by one or more individual indemnitors. The portion of the individual's bankruptcy estate that is available for the satisfaction of unsecured debts is often too small in scope to satisfy a meaningful portion of the

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[1] 11 U.S.C. §727 (a)(1). See 4 Colliers on Bankruptcy, P.727.01[2] at pp. 727-7-727-10; Norton on Bankruptcy Law & Practice 2d, §74:2 at pp. 74-5-74-6.

[2] 11 U.S.C. §1141 (d)(1)(A).

[3] 11 U.S.C. §1141 (d)(3).

indemnity obligation. However, there may be reason to believe that the individual is likely to accumulate assets sometime after the bankruptcy proceeding is concluded. The individual may have a demonstrated history of experiencing boom and bust cycles as a developer, investor, or contractor.[4] The individual may emerge from bankruptcy with certain assets intact because of state or federal exemptions or because the bankruptcy court concludes that the assets are so heavily encumbered by secured debt that the cost of foreclosing on the assets may exceed the likely return for unsecured creditors. However, upon the assets being abandoned by the bankruptcy estate, the unencumbered or nonexempt equity may appreciate in value or the individual may cut a deal with secured creditors which results in a reduction in the amount of the secured debt. Moreover, if a nondischargeability claim relating to a specific debt prevails, there may be no other creditors which would have a legal right to compete with the surety for assets retained or accumulated by the debtor following its discharge from its other debts.

The bankruptcy process is heavily biased in favor of granting

[4] The corporate principal may emerge from a Chapter 11 proceeding as a functional entity and the individual indemnitor may continue as an insider or member of management.

each individual debtor an entirely clean slate.[5] However, recent case law, while reaffirming the "fresh start" principle, has carefully limited "the opportunity for a completely unencumbered new beginning to the 'honest but unfortunate debtor.'"[6] The task confronting a creditor alleging nondischargeability is to convince a bankruptcy court that the debtor's conduct evidences a sufficient degree of fault or culpability to overcome the presumption in favor of an entirely fresh start.

The Bankruptcy Code sets out grounds for a finding of nondischargeability limited to a specific debt based on a finding of misconduct by the debtor in regard to that debt.[7] There are two paradigm situations in the surety context that may lend themselves to such a finding. The first address contexts where surety credit was secured based on false representations regarding the financial condition of the principal or indemnitor. Though of significance, dischargeability theories pertinent to this fact pattern are beyond the scope of this paper.

The other nondischargeability paradigm implicates contexts

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[5] See Grogan v. Garner, 111 S.Ct. 654, 659 (1991).

[6] Id.

[7] 11 U.S.C. §523.

where, prior to a bankruptcy filing, an individual indemnitor is responsible for the principal diverting significant portions of contract proceeds for purposes unrelated to a bonded job. This course of conduct may violate the principal's and indemnitor's legal obligations in the following respects:

1. the diversion of contract funds may violate a trust fund statute which requires that contract proceeds be applied in the first instance to pay obligations owing from the principal to its laborers, subcontractors and vendors;

2. the diversion of contract funds may violate the provision of most indemnity agreements that impresses a trust on contract proceeds requiring that these funds be applied in the first instance to pay obligations owing from the principal to its laborers, subcontractors and vendors;

3. the diversion of contract funds may violate one or more provisions of a construction contract requiring that contract proceeds be applied in the first instance to pay obligations owing from the principal to its laborers, subcontractors and vendors;[8] or

4. the diversion of contract funds may violate one or

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[8] See AIA Document A201 - General Condition of the Contract for Construction.

more provisions of a payment bond requiring that contract proceeds be applied in the first instance to pay obligations owing from the principal to its laborers, subcontractors and vendors.[9]

The diversion of contract proceeds in violation of statute or contract may result in a finding of nondischargeability in regard to the individual indemnitor's debt to the surety up to the amount of the diverted funds.

The Bankruptcy Code also states criteria for denying a debtor a discharge from all of its debts.[10] The impermissible diversion of contract proceeds may, under limited circumstances, constitute grounds for denial of discharge. The Code denies a discharge to an individual debtor, inter alia, where that person: (1) was a director, officer, or person in control of a corporation which was in bankruptcy and (2) engaged in certain kinds of misconduct

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[9] See AIA Document A312 - Payment Bond.

[10] The criteria which are most commonly applied to deny an individual a discharge involve situations where the debtor has engaged in some misconduct in the course of the bankruptcy proceeding, has wrongfully failed to keep or preserve financial records, or has transferred or concealed its property with an intent to hinder or defraud a creditor. 11 U.S.C. § 727. While these conditions may exist in the context of a bankruptcy petition filed by an individual indemnitor, except as noted above, there is nothing in the typical pattern of conduct by a financially troubled principal and an individual indemnitor that would make individual indemnitors, as a class, particularly vulnerable to a blanket finding of nondischargeability.

related to the corporate bankruptcy.[11] The contemplated misconduct may include the wrongful diversion of contract proceeds away from a corporate principal.[12]

Two provisions in the Bankruptcy Code, 11 U.S.C. §§ 523 (a)(4) and (a)(6), lend themselves to a finding of nondischargeability in regard to a particular debt based on a diversion of contract proceeds. Two provisions in the Bankruptcy Code, 11 U.S.C. §§ 727 (a)(2)(A) and (a)((7), when read in tandem, create the possibility that a diversion of contract proceeds could result in a blanket finding of nondischargeability in regard to all obligations of an individual indemnitor.

§523(a)(6)

11 U.S.C. §523(a)(6) states:

> (a) A discharge ... does not discharge an individual debtor from any debt-
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> (6) for willful and malicious injury by the debtor to another entity or to the property of another entity....

There is a split of authority regarding the scope of this provision. The minority view requires an intentional act with the

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[11] 11 U.S.C. §727(a)(7).

[12] 11 U.S.C. §727 (a)(2)(A).

specific intent to cause injury.[13] However, the majority of courts does not require proof of a specific purpose on the part of the debtor to cause injury to a creditor. It is enough that the debtor commits a wrongful act done intentionally, which necessarily produces harm and is without just cause or excuse.[14]

The difference between the minority and majority views reflects a concern on the part of some courts to assure that a debtor be accorded a fresh start in its entirety. Under this view, the fact that the debtor initiated a course of conduct that was inevitably likely to impair a creditor's interests does not evidence a sufficient level of misconduct unless the debtor purposefully intended to subject the creditor to injury. [15]

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[13] See In re Pasek, 983 F.2d 1524 (10th Cir. 1993).

[14] See, e.g., Vulcan Coals, Inc. v. Howard, 946 F.2d 1226 (6th Cir. 1991); Littleton v. Transamerica Commercial Finance Corp., 942 F.2d 551 (9th Cir. 1991); In re Modicue, 926 F.2d 452 (5th Cir. 1991); Chrysler Credit Corp. v. Rebhan, 842 F.2d 1257 (11th Cir. 1988); In re Stelluti, 163 B.R. 699 (Bkrptcy S.D.N.Y. 1994); In re Fugazy, 157 B.R. 761 (Bkrptcy S.D.N.Y. 1993).

[15] In re Pasek, 129, B.R. 247 (Bkrtcy. D. Wy. 1991), aff'd, 983 F.2d 1524 (10th Cir. 1993) (Where the debtor's former employees sued to enforce a covenant not to compete, the debtor's knowing breach of the covenant was not "willful and malicious" since he was not motivated by a desire to provide for his family and not to injure his former employer.).

However, the gulf between the minority and majority views may

It is well established under §523(a)(6) that a debtor who has wrongfully and illegally disposed of property which is subject to a security interest is at risk of having its debt to the secured party declared nondischargeable up to the value of the merchandise or funds which are wrongfully diverted.[16]

It can be argued that these cases are directly analogous to the diversion of contract proceeds since the general indemnity agreement creates a security interest in contract proceeds in favor of the surety; albeit a security interest that the surety generally chooses not to perfect.[17] Alternatively, these cases are at least persuasive since the diversion of contract proceeds and secured property involve the disposal of property which a debtor holds under a commitment to apply the property for the benefit of its

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not be as wide as it may first appear since, even under the minority view, evidence that the debtor's acts were certain to cause injury to a creditor and were without justification is persuasive evidence of the fact that the debtor acted with an intent to injure.

[16] See, e.g., In re Routson, 160 B.R. 595 (Bkrtcy. D. Minn. 1993); In re Collins, 151 B.R. 967 (Bkrtcy. M.D. Fla. 1993); In re Suydam, 151 B.R. 436 (Bkrtcy. N.D. Ohio 1992); In re Brouillet, 138 B.R. 338 (Bkrtcy. D. Mass. 1992).

[17] See In re Muto, 124 B.R. 610 (Bkrtcy. M.D. Fla. 1991) (ordering the nondischargeability of a debt due to the conversion of security despite the fact that the creditor's security interest had not been perfected). In re Sain; 101 B.R. 30 (Bkrtcy. C.D.Ill. 1988) (same) In re Wilson, 126 B.R. 122 (Bkrtcy. M.D. Fla. 1991) (same).

creditor. [18]

A claim that an individual indemnitor's debt to a surety should be nondischareable due to the debtor's complicity in a diversion of contract proceeds is highly fact specific. The pertinent issues that should inform a decision as to the advisability of pursuing such a claim include the following:

(1) In order to prove that a diversion was "willful", there must be evidence that the individual indemnitor/debtor participated in the diversion or knew of the diversion and had sufficient

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[18] There is a conflict in the case law regarding whether §523(a)(6) applies to willful and malicious contract breaches as well as malicious and willful torts. Compare Matter of Hallahan, 936 F.2d 1496 (7th Cir. 1991) (wilful and malicious contract breaches are nondischargeable); In re Kataner, 149 B.R. 395 (Bkrtcy. E.D. Va. 1992) (same); In re Dubian, 77 B.R. 332 (Bkrtcy. D.Mass. 1987) (same) with In re Calclasier, 134 B.R. 29 (Bkrtcy. W.D. Okla. 1991) (limiting the statute to malicious and wilful torts). The more limited view of the statute pose no problem for purposes of the diversion of secured property since the secured party can allege a malicious and wilful conversion by virtue of its ownership interest in the secured property. Though a conversion claim is not available in regard to the diversion of contract proceeds, a surety may be able to claim that a malicious wilful diversion states a cause of action for some or all of the following torts: breach of the covenant of good faith and fair dealing implied in an indemnity agreement; tortious interference in the contractual relationship of the surety and the individual indemnity principal to the extent that the individual indemnitor/debtor caused the principal to divert contract proceeds; or a wilful and malicious breach of contract.

authority to influence or stop the illegal conduct.[19] The willfulness requirement creates an impediment to a claim that a nondischargeability finding should be applied vicariously to the spouse of an individual indemnitor ("the outsider spouse") who had also executed the indemnity agreement but had had no direct conduct with the principal's daily operations or financial decisions.[20] However, it has been suggested that an outsider spouse may be liable for its spouse's illegal diversions where the outsider spouse authorized the insider spouse to act as its agent in making business decisions or where the outsider spouse ratified the actions of the insider spouse.[21] Similarly, it ha been held that

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[19] See Chrysler Credit Corp. v. Rebhan, supra, 840 F.2d 1257.

[20] See In re Stelluti, 163 B.R. 699 (Bkrtcy. S.D.N.Y. 1994); In re Jarrell, 129 B.R. 29 (D.Del. 1991); In re Martz, 88 B.R. 663 (Bkrtcy. E.D. Pa. 1988); In re Daleske, 49 B.R. 49 (Bkrtcy. W.D. Mo. 1985). Compare Transamerica Commercial Finance Corp. v. James, 152 B.R. 994 (M.D. Fla. 1992); In re Nielson, 97 B.R. 269 (Bkrtcy. W.D.N.C. 1989).

The possibility of a nondischargeability finding against one spouse but not the other creates the risk that assets accumulated following the bankruptcy will be held in the name of the outsider spouse. Any transfers that cause this result may be vulnerable to a fraudulent conveyance claim based on a finding of either actual or constructive fraud.

[21] See In re Paolina, 89 B.R. 453 (Bkrtcy. E.D. Pa. 1988);; In re Daeske, supra, 49 B.R. 49.

the wilful and malicious acts of a business partner may be imputed to another partner for purposes of a nondischargeability determination under §523(a)(6), as a matter of agency law, irrespective whether the other partner was aware of the wrongful conduct.[22]

(2) The surety must be able to prove that the individual indemnitor/debtor knew that the diversion of contract funds was wrongful.[23] Where an indemnitor concedes such knowledge, it might argue that the surety or its agents were aware of the diversions and impliedly authorized this conduct or waived the right to challenge this practice by its failure or delay in posing an objection.[24]

(3) It is uncertain whether a surety must prove that the individual debtor diverted contract proceeds for personal purposes to the detriment of the principal. An indemnitor may argue that

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[22] See Matter of Luce, 960 F.2d 1277 (5th Cir. 1992); In re Cecchini, supra 780 F.2d 1440; In re Calhoun, 131 B.R. 757 (Bkrtcy. D.D.C. 1991).

[23] See In re Posta, 866 F.2d 364 (10th Cir. 1989); In re Walsh, 143 B.R. 691 (Bkrtcy. N.D. Ohio 1992).

[24] See Davis v. Aetna Accept Co., 293 U.S. 328 (1934); in re Freeman, 30 B.R. 704 (Bkrtcy. W.D. La. 1983); But see In re Wolfson, supra, 148 B.R. at 644 (A secured creditor's failure to supervise the debtor's disposition of collateral does not excuse the debtor's diversion of secured funds.).

funds were diverted from debts incurred on the bonded jobs in order to underwrite the principal's overhead or pay debts incurred on other jobs. The indemnitor may clam that this use of funds created the best likelihood that the principal could continue in operation and ultimately minimize or obviate a loss to the surety. As such, the indemnitor could claim that there was far less than a certainty that the surety would suffer injury as a result of the diversions.

This argument would succeed under the minority view so long as the factfinder concluded that the individual indemnitor in fact believed that the diversions were in the best financial interests of the principal, and ultimately not contrary to the interest of the surety, irrespective whether this view was objectively reasonable.[25]

The success of this argument under the majority view is less clear. One line of causes appears to hold that where an individual debtor has diverted funds or property subject to a security interest, a finding of nondischargeability must be limited to any sums applied for personal purposes and should not include those

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[25] See cases cited at note 11, supra.

"secured" funds that were used to keep the business in operation.[26] A more favorable line of cases seems to suggest that all diverted funds subject to a security interest should be included in a nondischargeability finding since it should be presumed as a matter of law that the conversion of secured funds necessarily works to the detriment of the secured creditor.[27]

Based on the requirement under the majority view that a debtor's wrongful act must "necessarily produce harm", it is possible to imagine a middle ground; namely, that the factfinder would determine the earliest date on which it was objectively clear that the principal's operation was not financially sustainable over the long term, and hold that all diversions made after that date would be nondischargeable while, in regard to diversions preceding that date, only those directed for personal purposes would be nondischargeable.

4. In evaluating the advisability of bringing a nondischargeability action, the surety must also consider the

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[26] See In re Littleton, supra, 942 F.2d 551; In re Phillips supra 882 F.2d 302; In re Long, 774 F.2d 875 (8th Cir. 1985); In re Graham, 7 B.R. 5 (Bkrtcy. D. Nev. 1980).

[27] See In Re Routson, 160 b.r. 595 (Bkrtcy. D.Minn. 1993); In Re: Wolfson, Supra, 148 B.R. 678; In Re Collins, 151 B.R. 967 (Bkrtcy. M.D. Fla. 1993); In re Brouillet, 138 B.R. 338 (D.Mass. 1992).

likely amount of a nondischargeable judgment. It is possible under either the minority or majority views that the amount of the debt deemed nondischargeable may be limited to those funds which were diverted for the personal financial benefit of the indemnitor. It is also possible, under the majority view, that the amount of the nondischargeable judgment could include all of the contact funds that were diverted from the bonded projects.

In sum, §523 (a)(6) offers sureties a litigation option, as well as a bargaining chip for negotiation purposes, that may be apposite where the principal and individual indemnitors seek bankruptcy protection after diverting contract proceeds from bonded projects.

§523(a)(4)

§523(a)() states, in pertinent part:

> (a) A discharge ... does not discharge an individual debtor from any debt-
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> (4) for fraud or defalcation while acting in a fiduciary capacity ....

For purposes of this statute, "defalcation" is defined as the failure of a fiduciary to properly account for funds entrusted to him regardless that such failure may be the result of ignorance or

negligence.[28] There is no requirement that the debtor act with an illicit intent.[29]

The absence of a mens rea requirement has generated substantial concern that the discharge exemption embodied in §523(a)(4) is at war with the bankruptcy policy favoring discharge and a fresh start.[30] In theory, a debtor whose actions are well intentioned could be denied a discharge due to mistakes committed in a fiduciary role. Moreover, there could be many such "innocent" debtors at risk of nondischargeability since many typical debtor/creditor relationships could give rise to a form of trust. For instance, it could be argued that where a factor misapplies property that is held for the benefit of its creditor, the law impresses the misappropriated property with a constructive trust.[31]

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[28] See In re Brown, 131 B.R. 900 (Bkrtcy. D.Me. 1991); In re Jenkins, 110 B.R. 74 (Bkrtcy. M.D. 1990); In re Burgess, 106 B.R. 612 (Bkrtcy. D. Nev. 1989).

[29] Id.

[30] Norton on Bankruptcy Law & Practice 2d, §47:27 at pp. 47-57-47-60.

[31] Davis v. Aetna Acceptance Co., supra 293 U.S. 328 (1934). See In re Schusterman, 1098 B.R. 893 (Bkrtcy. D. Conn. 1989) (addressing whether revenues from the sale of lottery tickets held by the proprietor of a convenience store are held in trust in favor

Additional concerns have been stated regarding the potential scope of §523(a)(4). If a "fiduciary" label is applied to a particular commercial relationship, the funds held by the fiduciary may be labeled as "trust funds." This designation could lead to a further claim that the funds are the property of the beneficiary of the fiduciary relationship and not of the debtor or bankruptcy estate. For instance, if a factor holding funds for another is deemed to have created a constructive trust by virtue of its diversion of these funds, the factor's bankruptcy estate could be required to return these funds to the party for whom the funds were being held, thereby creating a preference over secured creditors and unsecured creditors. In the view of some bankruptcy courts, such a result would be anathema to the bankruptcy process.[32]

In order to obviate the perceived disadvantages associated with a broad interpretation of §523(a)(4), the courts have narrowly limited those fiduciary relationships that will be recognized under the statute. This has been accomplished, in large part, by requiring a technical trust relationship, generally in the form of

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of the state and are therefore not part of the store's bankruptcy estate).

[32] See In re Cargile, 151 B.R. 854 (Bkrtcy. S.D. Ohio 1993).

an explicit trust, that must arise before the act of wrongdoing and not a result of the act of wrongdoing.[33] Constructive trusts, or other trusts implied in law, are inapposite for purposes of a §523(a)(4) analysis.[34]

The narrowing of the scope of §523(a)(4) has also been accomplished by excluding from coverage certain seemingly explicit trust arrangements created by either contract or statute. As a consequence, it has been difficult for sureties to successfully argue that the acts of individual indemnitors in orchestrating the diversion of contract proceeds rises to the level of a defalcation while acting in a fiduciary capacity.

There are two approaches to overcoming these hurdles. First, a surety can argue that a trust cognizable under §523(a)(4) has been created by statute, indemnity agreement, construction contract, or payment bond. Alternatively, the surety can argue that the indemnitor's status as a corporate officer or director should create the necessary breach of fiduciary duty for purposes of §523(a)(4). These theories, as well as their implications for

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[33] See Davis v. Aetna Acceptance Co., 293 U.S. 328 (1934); In re Pedrazzini, 644 F.2d 756 (9th Cir. 1981).

[34] Id.

securing the nondischargeability of debts owed by "outsider spouse indemnitors", are discussed below.

(a) Trust Fund Statutes

Whether a trust fund statute creates a trust that will be cognizable under §523(a)(4) is dependent upon the terms of the particular statute.

Where a statute merely imposes criminal or other penalties for the failure to apply contract proceeds to a project, the courts have held that the statute does not create a relationship cognizable under §523(a)(4).[35] The rationale is that any trust relationship created by these statutes does not arise prior to and independent of the wrongful conduct.

The courts will recognize a trust relationship for purposes of §523(a)(4) where a statute expressly designates contract proceeds received by a contractor as "trust funds" and imposes specific duties on the contractor, including that the funds be held in a segregated account and that there be detailed recordkeeping regarding receipts and disbursements from the segregated account.[36]

The uncertain cases are those where a statute refers to

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[35] See In re Cross, 666 F.2d 873 (5th Cir. 1982)(Georgia Law); In re Angelle, 610 F.2d 1335 (5th Cir. 1980)(Louisiana Law); In re Dloogoff, 600 F.2d 166 (8th Cir. 1979)(Nebraska Law).

[36] See In re Kawczynski, 442 F. Supp. 413 (W.D.N.Y. 1977).

disbursed contract proceeds received by the contractor as "trust funds" but does not specifically impose duties upon the contractor with respect to these funds, such as maintaining segregated accounts or engaging in recordkeeping.[37] The outcome of these cases tends to be determined by the text of the particular statute. Language expressly prohibiting the diversion of funds for purposes other than the payment of vendors and subcontractors is a helpful element. References to criminal and other penalties or to the fraudulent disposition of funds creates a negative inference.

One bankruptcy court has suggested that trusts imposed by statute rather than by contract are not true express trusts and therefore are not cognizable under §523(a)(4).[38] This view has not gained currency in the case law.[39]

b. Indemnity Agreements and Contract

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[37] See In re Boyle, 819 F.2d 583 (5th Cir. 1987) (Texas Law does not create a trust cognizable under §523(a)(4)); In re Pedrazzini, 644 F.2d 756 (9th Cir. 1981) (California Law creates a trust cognizable under §523(a)(4)); Carey Lumber Co. v. Bell, 615 F.2d 370 (5th Cir. 1980) (Oklahoma Law creates a trust cognizable under §523(a)(4)); In re Johnson, 691 F.2d 249 (6th Cir. 1982) (Michigan Law creates a trust cognizable under §523(a)(4)).

[38] In re Holmes, 117 B.R. 848 (Bkrtcy. D. Md. 1990) (holding that Maryland's trust fund statute does not create a trust that is cognizable under §523(a)(4).

[39] In re Marino, 115 B.R. 863 (Bkrtcy. D.Md. 1990) (holding that Maryland's trust fund statute creates a trust that is cognizable under §523(a)(4).

and Payment Bond Provisions.

The case law is in flux regarding whether a trust cognizable under §523(a)(4) is created by the "trust" language in indemnity agreements or language in construction contracts and payment bonds which obligate the contractor to apply contract funds to pay debts incurred on the particular job to subcontractors, laborers, and vendors.

In Matter of Jenkins,[40] a surety successfully invoked §523(a)(4) to deny a full discharge to a contractor who had diverted contract proceeds from a bonded job for his personal purposes. The court found that the following "trust" provision from an indemnity agreement created a fiduciary obligation running in favor of the surety which was breached by the principal:

> The Undersigned ... agree to hold all money or other proceeds of a Contract ... as a trust for the benefit of Surety and to use such money or other proceeds for the purpose of performing the Contract and discharging the obligations of the Bond, and for no other purpose until the Bond is completely exonerated.[41]

In Federal Insurance Co. v. Fifth Third Bank (hereafter Fifth

[40] 110 B.R. 74 (Bkrtcy. M.D. Fla. 1990).

[41] Id.

Third Bank),[42] a surety in a nonbankruptcy context sought priority against a contractor's assignee bank to funds held in the contractor's account at the bank that could be traced to contract proceeds from a bonded job. In ruling for the surety, the court found that these funds were impressed with a trust by virtue of a provision in the underlying construction contract requiring that contract proceeds be held "in trust for payment of any and all obligations relating to this contract ...."

In In re Cargile Contractor,[43] a construction manager held contract proceeds as of the time of the contractor's bankruptcy filing. The surety, which had not yet paid a claim, argued that these contract proceeds were impressed with a trust requiring that the funds be paid by the construction manager to the unpaid subcontractors and vendors. The surety's "trust" argument was predicated on language in the construction contract identical to that at issue in Fifth Third Bank. The surety also relied on the following provision of its indemnity agreement:

> [I]t is expressly understood and declared that all monies due and to become due under any contract or contracts covered by the Bonds are trust funds, whether in the possession of the Indemnitor or Indemnitors or otherwise, for

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[42] 867 F.2d 330 (6th Cir. 1989).

[43] 151 B.R. 854 (Bkrtcy. S.D. Ohio 1993).

> the benefit and payment of all such obligations in connection with any such contract or contracts for which the Surety would be liable under any of said Bonds ... [This] trust also insures [sic] to the benefit of the Surety for any liability or loss it may have to sustain under any said Bonds, and this Agreement and declaration shall also constitute notice of such trust.

Despite the fact that Cargile arose in the Sixth Circuit, the bankruptcy court deemed the holding in Fifth Third Bank inapposite. The court determined that construing the indemnity agreement and construction contract as creating a trust would be contrary to the priority scheme of the Bankruptcy Code since the result would be to allow unsecured creditors, subcontractors, and vendors to gain a priority over other unsecured creditors. The court believed that this result was particularly inappropriate under the facts in Cargile since none of the subcontractors and vendors had validly perfected security interests under the state's mechanics lien law.[44]

In yet another Sixth Circuit case, In re Construction Alternatives[45], a contractor's bankruptcy estate sought to recover undisbursed contract proceeds from an owner on a completed project.

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[44] But see Universal Bonding v. Gittens and Sprinkle Enterprises, 960 F.2d 366 (3rd Cir. 1992).

[45] 2 F.3d 670 (6th Cir. 1993).

A surety which had sustained losses as a result of payment bond claims asserted priority to the funds. The Internal Revenue Service claimed priority over the surety by virtue of tax lien filings against the property of the contractor.[46]

The surety in Construction Alternatives alleged that the contract proceeds were subject to a trust in its favor by virtue of the "trust" provision of its indemnity agreement which was virtually identical to that at issue in Cargile.

The Court in Construction Alternatives noted that to create an express trust, the contracting parties must creating a res. They must also intend that the funds at issue be maintained by a trustee in a segregated account for the benefit of the payor or a third party, as opposed to a situation where the payee has unrestricted use of funds conveyed by the payor and needs to convey equivalent funds to the payor or a third person at a later time. The court held that because the indemnity agreement did not expressly require that contract proceeds be segregated by the contractor, no trust corpus had been created and therefore there could not be a trust.

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[46] Due to the court's unusual interpretation of the owner's rights under the construction contract and the rights of the payment bond claimants who were paid by the surety, the surety could not successfully argue that the tax lien did not attach to the contract funds because the contractor lacked a property interest in the funds or that the surety held an equitable lien over the contract proceeds which was entitled to a super priority.

The decisions in Cargile and Construction Alternatives reflect a fundamental misunderstanding of suretyship and trust law and their interplay with bankruptcy law. Where there are contract proceeds retained by an owner, the bankruptcy process will recognize a priority in favor of a completing surety over secured and unsecured creditors based on subrogation principles and the common sense notion that the debtor/contractor would not have gained an entitlement to the funds but for the payments and/or performance by the surety.[47] It would not be inconsistent to recognize a similar priority where contract proceeds subject to a trust provision in an indemnity agreement are in the control of the contractor, its bank or a construction manager.

It is true that the essence of a trust is that the trust res will be segregated from other funds. However, a document can create an express trust without explicitly stating that trust funds must be segregated in a separate account.[48] If the parties intend that an express trust be created over a discrete res, the obligation to segregate the trust funds arises as a matter of common law,

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[47] See In re Alliance Properties, 104 B.R. 306 (Bkrtcy. S.D. Cal. 1989); In re Pacific Marine Dredging, 79 B.R. 924 (D. Ore. 1987))

[48] See In re Menendez, 107 B.R. 789 (S.D. Fla. 1989). But see In re Graham, 7 B.R. 5 (Bkrtcy. D. Nev. 1980).

irrespective whether the trust document explicitly addresses the segregation requirement.[49]

Because, a §523(a)(4) proceeding does not result in the moving party securing a priority over the creditors to specific property, it is a more favorable procedural context than a priority dispute over property for addressing whether language in an indemnity agreement, a payment bond, or a construction contract imposes a trust over contract proceeds. However, the foregoing cases reflect that a surety faces a decidedly uphill struggle in convincing a court to recognize such a trust, irrespective of the facts in the particular proceeding.

c. Applying §523(a)(4) to Corporate Officers and Directors

As a matter of common law and sometimes by statute, corporate officers and directors owe a fiduciary duty to the corporation.[50] This obligation is breached where the officer or director diverts corporate funds for personal gain, particularly at a time when the

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[49] Restatement of Trusts Second, §§23, 24, 179.

[50] See, e.g., John P. Maguire & Co. v. Herzog, 421 F.2d 419 (5th Cir. 1970); In re Bruving, 143 B.R. 253 (D. Colo. 1992).

corporation is insolvent or facing severe financial pressures.[51]

The question arises whether a surety can claim nondischargeability under §523(a)(4) against a corporate officer or director, whether an indemnitor or not, who diverts contract proceeds from a bonded project for personal gain.[52] This question poses two issues.

First, this kind of fiduciary duty is unlike those most commonly recognized under §523(a)(4) in that it doe not arise out of an express trust. On the other hand, this duty shares a bond with the fiduciary relationships most commonly acknowledged under §523(a)(4) in that it arises prior to the alleged improper conduct and not as a consequence of that conduct.

The majority of courts that have addressed the issue recognize that a breach of fiduciary duty by a corporate officer or debtor can be grounds for a nondischargeability finding under §523(a)(4).[53] Many of these decisions rely on the fact that the

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[51] Id.

[52] The breach of fiduciary duty by the officer or director would extend solely to corporate funds that were diverted for personal gain and not to those which were diverted to pay the corporate overhead.

[53] See In re Hammond, 98 F.2d 703 (2d Cir.), cert. denied, 305 U.S. 646 (1938); In re Bernard, 87 F.2d 705 (2d Cir. 1937); In re Schiraldi, 116 B.R. 359 (Bkrtcy. D. Conn. 1990); In re Snyder, 101

predecessor provision to §523(a)(4) under the Bankruptcy Act excepted from discharge debts created by a debtor while engaging in improper conduct as "an officer or in a fiduciary capacity." Though the reference to "an officer" was omitted from the Code §523(a)(4), the courts have held that this omission was not intended to have a substantive effect and rather reflected the removal of a term that was deemed superfluous due to the broad scope of the term "fiduciary."

Assuming that a breach of fiduciary duty by an officer or director can be a basis for a nondischargeability finding, there is a split in the case law as to whether standing to bring this claim rests solely with the victimized corporation or whether the claim can also be brought by a creditor of the corporation who suffered a loss as a result of the officer's or director's misconduct.[54] The outcome in there cases is heavily influenced by whether the common law in the forum state acknowledges a cause of action resting with a creditor of a corporation to sue officers or

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B.R. 822 (Bkrtcy. D. Mass. 1989); In re Desche, 36 B.R. 452 (D.N.D. 1983).

[54] Compare Matter of Cross, 666 F.2d 873 (5th Cir. 1982) (standing rests solely with the corporation) with John P. Maguire & Co. v. Herzog, 421 F.2d 419 (5th Cir. 1970) (creditor allowed to make claim); In re Bernard, 87 F.2d 705 (@d Cir. 1937) (same); In re Bruning, 143 B.R. 253 (D. Colo. 1992) (same).

director's of the corporation based on a breach of their fiduciary duty to the corporation.[55]

There are two factors which make a surety a particularly good candidate for being accorded standing to allege a breach of fiduciary duty owing to its principal. First, there is a virtual identical fit between the breach of duty to the corporation-- the diversion of funds for personal purposes-- and the cause of a surety's loss-- the diversion of contract proceeds for personal purposes. Second, where the surety has paid all claims under the payment bond, it has essentially held the corporation harmless for the diversion of funds by its officer and director. As such, the surety can argue that it should be subrogated to the corporation's right to make alleged claims against the offending officer or director.

The surety's entitlement to allege a breach of fiduciary duty by a corporate officer or director may be complicated where the corporation is intent on bringing the identical claim against its officer or director's bankruptcy estate. The surety's ability to successfully maintain a claim based on a breach of fiduciary duty could be further complicated if the principal's bankruptcy estate

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[55] Id.

seeks to bring a §523(a)(4) claim against a former officer or director's bankruptcy estate.

c. Claims against Spouses under §523(a)(4)

As §523(a)(4) does not require intentional misconduct, there might be a greater opportunity to implicate an "indemnitor/spouse" than under §523(a)(6). However, assuming that an indemnity agreement creates a trust over contract proceeds, a spouse could not be accused of a defalcation of its fiduciary duty unless that spouse misapplied the contract proceeds. If the outsider/spouse has little or no contact with the business, the likelihood of liability is remote.

There may be a greater opportunity of securing a nondischargeability judgment against an outsider spouse where that spouse is a corporate officer or director. Assuming that the insider spouse diverts contract funds for the benefit of his/her family, it could be argued that the outsider spouse has a responsibility to keep informed regarding corporate affairs and that his/her fiduciary duty is breached where s/he personally benefits from corporate funds, at the expense of the corporation, irrespective whether the use of corporate funds is knowing.

<u>§727(a)(2) and (a) (7)</u>

§727(a)(7) states:

> (a) The court shall grant the debtor a discharge, unless-
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> (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, ....

This provision extends liability in the event that an insider of a debtor who engages in acts of misconduct in connection with the debtor's estate files his/her own bankruptcy petition within one year of the date of the misconduct.[56]

The objective underlying §727(a)(7) is to provide an incentive for insiders of a debtor to conduct themselves in an ethical manner in the course of a debtor's bankruptcy.[57] This incentive is particularly warranted in light of the virtual unavailability of a finding of nondischargeability to punish a Chapter 11 corporate debtor for the illegal acts perpetrated on its behalf by its insiders.[58]

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[56] See In re Weber, 99 B.R. 1001 (Bkrtcy. D. Utah 1989); In re Kessler, 51 B.R. 895 (Bkrtcy. D. Kan. 1985). For the definition of an "insider," see 11 U.S.C. §101(28)(B)(ii).

[57] In re Weber, supra.

[58] See text accompanying footnotes 2 & 3, supra.

An insider may be denied a discharge for actions taken in regard to a corporation's bankruptcy estate which run afoul of §727(a)(2):

> (a) The court shall grant the debtor a discharge, unless-
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> (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-
>
> (A) property of the debtor , within one year before the date of the filing of the petition ....

A corporate insider who has induced the corporate debtor to "transfer or remove" contract proceeds dedicated to a bonded project has exposure under this statute if s/he acted with an intent to hinder or delay the surety. There must be evidence of a specific intent to hinder or delay the particular creditor, though the intent may be to temporarily and not necessarily permanently cause injury.[59]

A surety claiming nondischargeability of an individual indemnitor in reliance on §727(a)(2) will probably need to present evidence of diversions for the personal benefit of the individual

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[59] In re Weber, supra.

debtor in order to sustain its burden of proving a specific intent to inflict injury on the surety. Because of this requirement, it is unlikely that these claims will be successfully mounted against outsider spouses.

## Conclusion

The case law reflects a willingness on the part of secured creditors, particularly lending institutions, to seek nondischargeability judgments against debtors who converted property subject to a security interest. The dearth of nondischargeability cases brought by sureties suggests that an affinity for this tactic is not shared within the surety industry. In light of the availability of this remedy, the seeming failure of sureties to consider this option is at least worthy of reconsideration under cost benefit criteria.

In many cases where a surety seeks a nondischargeability finding due to the diversion of contract proceeds, the cause of action offering the best likelihood of success will likely be §523(a)(6) due to the intent requirement under §727(a) and the seeming reluctance on the part of bankruptcy courts to acknowledge for purposes of §523(a)(4) that the typical indemnity agreement creates a trust over contract proceeds in the custody of the principal. The prospects for success under §523(a)(4) could be

increased substantially if language was added to indemnity agreements requiring that contract proceeds be segregated by the contractor upon their receipt. This would be particularly desirable since a judgment under §523(a)(4) as opposed to one under §523(a)(6) is more likely to extend to all diverted funds rather than that portion applied for the personal financial benefit of the individual indemnitor.

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