SURETY TODAY PRESENTATION

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NON-DISCHARGEABILITY IN BANKRUPTCY

This is the fifth edition of the Surety Today tele-briefing. Our topic today is Non-Dischargeability in Bankruptcy. I will lead off with an overview of what non-dischargeability in bankruptcy is and then Jason is going to talk about a recent case that has come down from the Supreme Court on non-dischargeability as it affects the surety's salvage rights. That is partly what prompted this discussion today, the fact that in May 2016, the Supreme Court came out with a new decision on this area, and it's something we think should be talked about by sureties. I will follow up with a discussion of the Supreme Court decision in *Bullock v. BankChampaign*, which was a 2013 decision, also on non-dischargeability, which really had some ramifications for sureties as well.

OVERVIEW OF NON-DISCHARGEABILITY IN GENERAL

Mike: In order to understand non-dischargeability, you have to first understand dischargeability. A fundamental goal of the Bankruptcy Code is to give debtor's a financial "fresh start," so to speak. The Supreme Court observed long ago that the purpose of the bankruptcy system was 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." The various bankruptcy chapters, 7, 11 and 13 all provide for a discharge of the debtor.

Section 524 of the Bankruptcy Code addresses the effect of the discharge and generally provides a discharge of the debtor that releases the debtor from personal liability of pre-existing debt. Specifically, Section 524 provides that discharge of the debtor voids any pre-bankruptcy judgments against the debtor and operates as a continuing and permanent injunction against any enforcement or collection efforts of any creditors of any debts that are the subject of the discharge. The discharge under 524 of the Bankruptcy Code operates automatically by operation of law and any violation of the discharge by a creditor would be void and any violator would be subject to sanctions or penalties.

Notwithstanding the fresh start and discharge goal of bankruptcy, Congress has provided in the Bankruptcy Code that certain types of debt are not subject to the discharge, and thus, they are non-dischargeable; which means that even after the bankruptcy a creditor can pursue such debt against the debtor's post-bankruptcy assets. Section 523 of the Bankruptcy Code provides for exceptions to discharge, and it identifies some 21 different types of debts that are non-dischargeable. When you look at these exceptions, they are very detailed and there are all kinds of different things in there, but basically, there are two broad categories of debts that Congress has determined are exceptions to discharge.

The first category consists of those debts that are excluded for public policy reasons - so you have things in the Code like certain taxes that would be exempt or an exception from discharge, student loans are an exception from the discharge as are child support obligations. The second category that is an exception to the discharge under 523 are debts that were created as result of what you would call “bad behavior” - which are debts created by fraud, false pretense, intentional tort, etc. The courts have decided that all of these exceptions to discharge under 523 are to be narrowly construed in order to limit their affect and to broaden the scope of the fresh start. The party seeking non-dischargeability under 523 will bear the burden of proving the requirements by a preponderance of the evidence.

Non-dischargeability can be important to a surety because it can establish that your debt is not discharged and you can continue to pursue collection post-bankruptcy. Maybe there are some assets that were not part of the bankruptcy that you could gain access to, maybe the debtor has started a new company and you could get access to the funds coming from that or you can use the threat of non-dischargeability as a negotiation tool either pre-bankruptcy or post-bankruptcy in order to improve the surety’s position. It has relevance and is something that I know a lot of surety people have dealt with, I know we’ve dealt with it over the years, so whenever there are important cases in this area, it’s always good to talk about them. Jason, I’m going to turn it over to you regarding the recent Supreme Court case.

HUSKY INTERNATIONAL ELECTRONICS V. RITZ

Jason: Thank you. Mike indicated that the person challenging dischargeability bears the burden of proving it and that’s done through what’s called adversary proceedings. The debtor may list certain debts to inform the creditor that that particular creditor is among the list of creditors, and that creditor can file an adversary proceeding to challenge the dischargeability of that debt. That’s what happened in a recent case. The case is called *Husky International Electronics v. Ritz*, 136 S.Ct. 1581 (2016). Here, as Mike said, the case involved the interpretation of actual fraud as that term is used in the Bankruptcy Code. Actual fraud is one of the bases for non-dischargeability under the Code. An actual fraud is typically thought of as a situation where one individual makes a representation to another individual and the person making that representation knows it’s false, knows at the time of representation it’s false and the defrauded party relies upon it to its detriment.

At least in my mind, one of the more prominent examples or clearer examples in the surety context is in the underwriting stage when the principal and indemnitors go to the surety to get bonds. They may make certain misrepresentations to the surety, whether it is the amount of receivables or amount of the contract, the value of certain property, etc. As a result of those representations, the surety issues a bond. That is typically the situation involving actual fraud. In fact, that would be actual fraud under Maryland law as well.

The *Husky* case, involved a different take on actual fraud because it involved the fraudulent transfer of assets, which is commonly referred to as a fraudulent conveyance. A fraudulent conveyance is slightly different because in that situation, an individual may transfer property or money or other assets specifically for the purpose of defrauding creditors. However, there is no actual misrepresentation made and no reliance by the defrauded creditor. So, it is a slightly different take.

In *Husky*, Mr. Ritz owned a corporation, transferred a huge amount of corporate assets from one corporation to another corporation in order to evade corporate debt, and the creditors of that corporation then filed suit against both the corporation and Mr. Ritz individually under a Texas law that allowed him to be personally liable for that debt. As often happens, Mr. Ritz immediately filed bankruptcy, once he was sued individually. Mr. Ritz alleged that all the debt was dischargeable in bankruptcy and the creditors filed an adversary proceeding seeking to hold that the debt was non-dischargeable because there was actual fraud. The bankruptcy court disagreed, however, and it held that there was no actual misrepresentation made by the individual and there was no reliance upon those creditors because it was a fraudulent conveyance. Mr. Ritz simply transferred huge amounts of assets, he didn't make any representations whatsoever to the creditors, and in fact, any representations that he made were done so long after he had transferred that debt. The bankruptcy court therefore held that fraudulent conveyances did not fall within the purview of the actual fraud exception to discharge, and held that the debts were dischargeable. The creditors, of course, then filed an appeal to the US District Court and then to the 5th Circuit Court of Appeals, who also agreed with the bankruptcy court. They held that in order for actual fraud to exist under the Bankruptcy Code, there had to be fraudulent misrepresentation made by one to another and reliance by the other upon that to its detriment.

The Supreme Court ultimately issued certiorari and in a decision earlier this year reversed. As Mike mentioned, it was a pretty significant case for sureties because it held that in order for a debt to be non-dischargeable for actual fraud, there does not need to be an actual misrepresentation by the debtor to the creditor, nor reliance by that creditor upon any misrepresentation. It based its determination upon how courts have interpreted "actual fraud" going back hundreds of years. If you first look at the term "actual" in the term "actual fraud," it held that "actual" as federal courts have interpreted that term, "actual fraud" means moral turpitude or intentional wrong. That's important because it has distinguished between actual implied fraud or negligent misrepresentation in which there is no intent to deceive by the individual. The Court held that anything that counts as fraud, done with wrongful intent, is actual fraud. The Court then looked at fraud to determine whether a fraudulent conveyance can constitute actual fraud, and it again went back to cases over hundreds of years to find that courts in the federal arena, have traditionally held that fraudulent conveyances do constitute fraud. Therefore, it held that actual fraud can include a fraudulent conveyance, provided there is an intent by the individual to deceive when it makes those transfers.

Again, that is a significant holding for sureties because it extends the reach of actual fraud to situations where the indemnitors may work to evade the surety, particularly in salvage situations where the sureties may try to recoup some of its losses. The typical situation may involve an individual who might hide corporate assets, or may transfer money from one account to another. Pre- *Husky*, those debts may still be held to be dischargeable. However, after *Husky*, the surety can allege that such debts were fraudulent concealment, were fraudulent conveyances and therefore, the debts should be held as non-dischargeable. Now the case came out in May so there haven't been a lot of cases that interpret the *Husky* case, but one that I thought was interesting was a case out of the 10th Circuit, *In re Thompson*.

Now, Thompson was not a fraudulent conveyance case but did involve an actual fraud to someone other than the creditor. In *Thompson*, an individual who owned a nursing home facility, supplied certain applications to the State to create new nursing homes. As part of the application process, that individual falsely stated that he would operate those nursing homes, that he would oversee and supervise those nursing homes, and as a result of that application and those representations by that individual, the State granted a license to the company. An individual in the nursing home died and her spouse subsequently sued the nursing home and the individual. The individual, of course, filed bankruptcy, alleging that any debt to the deceased's individual spouse was dischargeable, but the 10th Circuit disagreed based upon, in part, the Supreme Court's holding in the *Husky* case because it said that the individual committed actual fraud to the state, the state reasonably relied upon those representations and as a result, issued a license to the individual and the nursing home. It therefore, held that any potential debt was not dischargeable.

There may be certain lessons that we, as sureties and surety counsel, may gain from *Husky* and its progeny and they really focus on intent. How do you prove intent? It seems to me that the easiest and most direct way to prove it is to show knowledge on behalf of the party. So, if you can show that an individual knew it had certain obligations and that individual violated those obligations, that creates a strong case for showing fraud. How do you do that, how do you show knowledge upon the individual? When an individual signs an indemnity agreement, have that individual attest to certain provisions in the indemnity agreement. When claims come in to the surety, the surety should reach out to the indemnitors to make sure that they know about their obligations under whatever common law exists in the jurisdiction, as well as the indemnity agreement and of course, we need to follow up those verbal communications with letters or with emails to document those conversations. We should make certain that with any post-default understandings or agreements, the indemnitors are placed on notice of their obligations to preserve contract funds or funds that they are obligated to preserve. In any underlying or subsequent litigation that precedes the bankruptcy, draft pleadings and issued discovery should be aimed at showing or proving what the indemnitor's state of mind is, showing that the indemnitor knew that it was obligated to preserve that property and that it did not abide by those obligations when the transfer was made. Once the bankruptcy begins, there is a 2004 examination, a meeting of creditors at which meeting the creditors can ask certain questions of the debtor. The creditors should ask questions that would prove that the debtor knew of those obligations and that the indemnitor acted to evade those obligations. I am going to turn this over to Mike now to talk about an earlier case that dealt with a similar issue.

BULLOCK V. BANKCHAMPAIGN

Mike: Thanks Jason. We're going to discuss the Supreme Court case of *Bullock v. BankChampaign,* 133 S. Ct 1754 (2013). It relates to a specific part of the 523 non-dischargeability Code section, specifically Code section 523(a)(4), which provides that an individual debtor is not discharged from any debt that was incurred by defalcation while acting in a fiduciary capacity. So, if a debtor while acting as a fiduciary, incurred a debt or liability as a result of a defalcation of their fiduciary obligations, then that debt would be excluded from discharge. So the keys to 523(a)(4) are whether there is a "fiduciary capacity" and whether "defalcation" occurred while the debtor was acting in that fiduciary capacity. Unfortunately, the Code does not define either fiduciary capacity or defalcation, so we are left with the Courts to figure it out. We will look at these two keys to Section 523(a)(4) and then get into the *Bullock* case.

(1) "Fiduciary Capacity" Under Section 523(a)(4)

The first key is "fiduciary capacity." From the very beginning of bankruptcy going back to the 1800's, the concept of fiduciary capacity was narrowly defined by the courts. So, there are a lot of relationships where parties may be described as a fiduciary in one sense or another. For example, agents and principals, bailees and bailors, brokers, factors, partners, have all been treated in various state law as fiduciaries. For the purposes of Section 523, those are not sufficient fiduciary capacities in order to trigger non-dischargeability. Relationships such as the trustee of a trust, executors or administrators of an estate, guardians and those types of relationships are the kind of fiduciary relationships that the Code is speaking to. Relevant to the sureties is the fiduciary capacity arising from the trustee/trust relationship because in many circumstances, sureties find themselves dealing with trust property. Not all trusts will satisfy Section 523 however. Only express or technical trusts will do the trick, so things like constructive trusts, resulting trusts, or implied trusts cannot create the necessary capacity under Section 523. The trust must exist prior to the bankruptcy and arise without reference to any wrongdoing. So, constructive, resulting and implied trusts are all sort of remedy-based trusts that apply after or as a result of wrongdoing, whereas Section 523 is focused on the fiduciary capacity of an existing trust relationship.

Sureties, of course, can find trusts in a variety of places – (i) the indemnity agreement, (ii) the construction contract, the underlying bonded contracts, through subrogation the surety could assert rights to trust fund provisions in those documents and (iii) trust fund statutes, there are many states that have trust fund statutes, and the surety again, through subrogation rights, can assert trust obligations through those statutes. You just have to be careful here and review the documents or the statutes that you're dealing with to make sure that they create an express trust. For example, some of the trust fund statutes don't apply to commercial construction; some don't apply if bonds were posted, some don't apply to a surety, so you have got to be careful with those trust statutes. Then the trust provisions themselves in the indemnity agreement or construction contract, even though Section 523 is federal law and the bankruptcy court looks to federal law, when the court has to determine what the property rights are that are subject to the federal law, the court will look at state law on that. You have to go jurisdiction by jurisdiction on that as to what is an express trust. Numerous courts have held that various trust provisions in the GAI and in construction contracts have created express trusts and there are plenty of cases out there for that. Some courts have gone the other way, based on either the facts or the language of the documents themselves, so you have to look at the issue of whether you've got an express trust. If you can establish the existence of the express trust and the debtor was the trustee, you'll have that necessary fiduciary capacity required by Section 523; you then need to establish defalcation.

(2) "Defalcation" Under Section 523(a)(4)

As noted earlier, the Bankruptcy Code does not define the term "defalcation." As a result, several definitions have arisen over the years. The 4th, 8th and 11th Circuits have all held that defalcation under Section 523 could occur from a mere failure to meet a fiduciary obligation, whether through negligence or innocent mistake. It didn't matter; there was no evidence of intent or recklessness required. Basically, if you were supposed to have $100 in your account and you didn't and you were the fiduciary, that would be defalcation for those circuits. The 5th, 6th and 7th Circuits developed a rule that defalcation under Section 523 required more than just negligence. There had to be some sort of willful, neglectful duty, something short of fraud. You didn't have to have the intent to deceive or the gross extreme recklessness, but you had to have more than just mere negligence in order to constitute defalcation. The third position was established by the 1st and 2nd Circuits, which held that defalcation required an intent to deceive, the scienter element of fraud, or extreme recklessness in order to satisfy the defalcation requirement of Section 523 and establish non-dischargeability. So, you've got this dramatic split among the Circuits with all of these different positions, and the Supreme Court finally, in the *Bullock* case, in 2013 put to rest the split and came out with a pretty tough standard; adopting the most restrictive standard.

(3) Non-Dischargeability in Section 523(a)(4) Under Bullock

The *Bullock* case itself was a typical self-dealing situation where the debtor was the trustee of the trust and he was basically taking loans out of the trust and self dealing for his own personal benefit. The Court looked at that, looked at the history of defalcation, looked at the split among the Circuits, and ultimately held that defalcation under Section 523 requires conduct including bad faith, moral turpitude of other immoral conduct or intentional wrongdoing. The Court clarified that intentional wrongdoing includes not only conduct at the fiduciary knows is improper but also reckless conduct. It defines reckless conduct as a conscious disregard of a substantial and unjustifiable risk that the conduct will turn out to violate the fiduciary duty. Later in the decision, the Court defined it as a gross deviation from the standard of conduct that a law abiding person would observe. So, the Court really put that restriction there on the non-dischargeability for defalcation and it's made the provision of Section 523 a lot more unobtainable for most folks.

Jason and I, along with Jessica Wynn of Alber Crafton and also Christina Craddock of Liberty put together a paper. It's a really good resource and we would like to send that to you later after the presentation. It's entitled "New Standards Affecting the Surety's Use of Section 523 in Non-Dischargeability of Bankruptcy" and that's a good discussion of the *Bullock* case with all the history of that particular subpart of Section 523 non-dischargeability. So, we'll get that out to you all and you can take a look at that to see in more detail. We simply don't have time to go into it here. The practice pointers that Jason pointed out are relative here too because when there's a defalcation, you have to establish that intent, that willfulness. You have to establish the knowledge that they were trustees, that there was a trust relationship and all of that. What you can do in advance to come up with that when you're doing the underwriting aspects, you're pointing out the trust fund provisions, maybe in the cover letter you're telling about it, maybe when the first claim comes in, you've got your letter going to the indemnitors saying "hey you are all are trustees, you've got a trust obligation" and just get that out to them in that way. During the initial investigation, you're looking for facts and information that are going to show this knowledge and show this intent to violate the trust obligation. You want to make sure that you locate and preserve all of the documents that are out there; particularly electronic documents, emails and all that can be critical to show what the parties were thinking at the time and why they were doing what they were doing. So, those are some general tips. With that we are finished with the discussion. We want to do a quick wrap with questions and answers.

The next edition of Surety Today will be October 10, 2016 at 12:30. The topic will be "The Surety's Obligation to Meet MBE Requirements." I'm sure everyone has run into this where your subcontractor or general contractor goes down on a job and then you've got to come in and meet the MBE requirements, or do you? That's the question. Cindy Rodgers-Waire and Lisa Sparks will be presenting on that topic.

A quick rundown of upcoming surety events:

- September 14: Philadelphia Surety Claims Association lunch in Philadelphia.
- September 21 – 23: Northeast Surety Claims Conference in Atlantic City. You can sign up for that on Forcon International's website. You can sign up online there and it's free for in-house company people. I hope to see everybody there. Wright Constable is a co-sponsor of that conference.
- October 5-7: National Bond Claims Association in Hilton Head, SC.
- November 9-11: FSLC Fall Meeting in Chicago
- November 17: Atlanta Surety Claims lunch meeting