

**SEVENTEENTH ANNUAL
NORTHEAST SURETY AND FIDELITY
CLAIMS CONFERENCE**

SEPTEMBER 21st and 22nd, 2006

**PURSUING NON-DISCHARGE ACTIONS AGAINST DEBTORS
IN FIDELITY AND MISCELLANEOUS BOND LOSSES - RISKS
AND REWARDS**

PRESENTED BY:

GARY M. CASE
WOLF, HOROWITZ, ETLINGER & CASE, LLC
99 Pratt Street, Suite 401
Hartford, CT 06106
(860) 724-6667
FAX (860) 293-1979

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Bond Losses - Risks and Rewards**

By

Gary M. Case

Wolf, Horowitz, Etlinger, & Case, LLC

99 Pratt Street, Suite 401

Hartford, CT 06106

860-724-6667

gcase@wolfhorowitz.com

www.wolfhorowitz.com

Introduction

For the fidelity insurer and commercial surety, losses are often caused by individuals who engage in fraud, defalcation or breach of fiduciary duties. For the fidelity insurer, a loss may be caused by a dishonest employee who steals money from an employer, requiring the insurer to satisfy the employer's claim under a fidelity bond or commercial crime policy. For the commercial surety, a loss may be caused by a principal who, while acting as a fiduciary, has misappropriated funds from an estate. In these cases, the surety incurs a loss when it makes payment to the estate or the successor fiduciary under the bond.

Under either scenario, the insurer or surety is faced with a loss caused by an identified person. Salvage efforts may be directed against that individual, including claims based on subrogation or assignment. Faced with such a claim, the wrongdoer may seek protection under the bankruptcy code. The bankruptcy code generally protects individual debtors from the prosecution of claims based on debts which arose prior to the bankruptcy filing. The most significant protection afforded to the debtor is the right of discharge. Once the debt is discharged, the creditor cannot collect or attempt to collect the debt.

A fidelity insurer or commercial surety faced with a bankruptcy filing by an individual debtor is presented with an important decision. The insurer or surety may choose to discontinue its salvage efforts as to the debtor. Alternatively, the insurer or surety may object to the discharge of the debt. This paper addresses the risks and rewards for pursuing such an objection. The discussion includes an overview of the rules and procedures governing non-discharge complaints, as well as a review of reported decisions involving fidelity insurers and commercial sureties.

Non-Dischargeable Debts Under The Code

For most individuals filing for Chapter 7 bankruptcy protection, the reason for filing the petition is to secure a "fresh start" – a chance to get out of debt. The key element of this fresh start is the order of discharge which enters at the conclusion of the case. Under this order, the debtor's debts and obligations to creditors listed on the debtor's schedules are discharged, and creditors are precluded from collecting or seeking to collect these debts for all time.

Congress has determined that certain types and categories of debts should not be discharged in bankruptcy. These exceptions to discharge are set forth in 11 U.S.C. § 523.¹

From the perspective of the fidelity insurer and the commercial surety, the most significant exception is contained in 11 U.S.C. § 523(a)(4):

A discharge .. under this title does not discharge an individual debtor from any debt – for fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny.

¹ The exceptions to discharge under § 523 should be distinguished from a challenge to discharge under 11 U.S.C. § 727. Claims under § 523 are based on specific debts owed by the debtor. In contrast, § 727 precludes discharge of all debts where the debtor has engaged in specified misconduct with respect to the bankruptcy proceeding itself. While a creditor may object to discharge under § 727, such a claim is beyond the scope of this paper.

Other categories which may, in the appropriate case, be relevant for a fidelity insurer or commercial surety include debts for money or credit obtained by false pretenses, a false representation or actual fraud; see § 523(a)(2); debts for willful or malicious injury by the debtor to another entity or to the property of another entity; see § 523(a)(6); and any final judgment or debt arising from fraud or defalcation while acting in a fiduciary capacity with respect to any federal depository institution or insured credit union. See § 523(11).

The Rules and Procedures Governing Objections to Discharge

The rules and procedures governing complaints objecting to discharge are set out in the Federal Rules of Bankruptcy Procedure. These rules generally track and incorporate many of the Federal Rules of Civil Procedure. In addition, each bankruptcy court and district has its own local rules. Practitioners should consult these rules since they often contain more specific filing and procedural requirements which must be followed.

Scheduled debts are discharged unless a creditor prevails in an action for a determination that the debt is not dischargeable. Pursuant to Fed. R. Bankr. P. 7001(6), actions to determine the dischargeability of a debt are adversary proceedings. Adversary proceedings are commenced by the filing of a complaint. Fed. R. Bankr. P. 7003. Thus, a surety or fidelity insurer must commence the action objecting to discharge by filing a complaint in the bankruptcy court. A sample complaint objecting to discharge by a bail bond surety is attached as an exhibit to this paper.

Rules for proper service of the complaint are set forth in Fed. R. Bankr. P. 7004. A complaint must be filed not later than 60 days after the first date set by the Court for the first meeting of creditors under 11 U.S.C. § 341. Fed. R. Bankr. P. 4007(c). This time period may only be extended on motion (filed before the deadline has expired) and for cause, provided that 30 days notice of the deadline is given to all creditors and parties in interest. Fed. R. Bankr. P. 4007(c).

Typically, the surety or fidelity insurer will receive an initial notice of a bankruptcy filing from the debtor. This notice will include a deadline for the filing of a complaint to object to discharge. Strict compliance with this deadline is required, and numerous courts having held that the deadline is jurisdictional: "The time limits in Rule 4007(c) have been held to be jurisdictional and therefore nonwaivable. . . ." See 9 Collier on Bankruptcy, 15th Ed. Rev'd, P 4007.04 [1] [a] (2001)(citing many cases including Burger King Corp. v. B-K of Kansas, Inc., 73 B.R. 671 (D. Kan. 1987)). Lack of receipt of the notice will not excuse a creditor from complying with the deadline where the creditor has actual knowledge of the bankruptcy in time to file a dischargeability complaint. See 9 Collier on Bankruptcy, 15th Ed. Rev'd, P 4007.04 [2] (2001).

Once an adversary complaint objecting to discharge has been filed, the matter progresses like a civil action, and many of the Federal Rules of Civil Procedure apply. Significantly, a surety or fidelity insurer may wish to pursue discovery, which is made applicable to non-discharge actions pursuant to Rule 7026 et seq. of the Federal Rules of Bankruptcy Procedure, and a motion for summary judgment, which is made applicable to non-discharge actions pursuant to Rule 7056 of the Federal Rules of Bankruptcy Procedure. However, unlike a typical federal civil case, an adversary proceeding objecting to discharge is

not conducted on a level playing field. Instead, the rules deliberately favor the debtor. Exceptions to discharge are construed strictly against the creditor and liberally in favor of the debtor (and in favor of discharge). See e.g. Union Planters Bank Nat'l Ass'n v Martin (In re Martin) 306 BR 591. (Bankr. CD Ill 2004).

Whether by summary judgment or by trial, the bankruptcy court must determine whether the debt owed is nondischargeable, and will enter a judgment accordingly. The parties may also ask the bankruptcy court to determine the amount of damages and enter a judgment liquidating the debt. While some bankruptcy courts have held that they do not have the authority to enter money judgments on debts, most courts have concluded that they have such authority. Compare In re Freidman, 300 B.R. 149 (Bankr. D. Mass. 203) (bankruptcy courts have jurisdiction to enter money judgments on nondischargeable debts), with Am. Express Centurion Bank v. Losanno (In re Losanno), 291 B.R. 1 (Bankr. D. Mass. 2003) (bankruptcy courts have no authority to enter money judgments in nondischargeability cases), and Barrows v. Illinois Student Assistance Comm'n (In re Barrows), 182 B.R. 640, 653 (Bankr. D.N.H. 1994) (money judgments "should be left to a court of competent jurisdiction as would have occurred had there been no bankruptcy").

Judgments of the bankruptcy court are subject to appeal to the district court or bankruptcy appellate panel pursuant to 11 U.S.C. § 158 and Fed. R. Bankr. P. 8001.

Claims By Fidelity Insurers

There are a handful of reported decisions in which fidelity insurers have pursued non-discharge actions. In these cases, the courts focused on the following issues: (1) the fidelity insurer's standing to assert claims of nondischargeability where the insurer had paid claims of its insured and pursued claims via subrogation or assignment; and (2) whether prior judgments would be given res judicata or collateral estoppel effect in the insurer's non-discharge case, including prior criminal convictions of the employee.

A fidelity insurer pursued a non-discharge claim after it had paid its insured on a loss in In Re Graziano, 35 B.R. 589 (Bankr. E.D.N.Y. 1983). Here, the insured was a fruit wholesaling company. It was covered by a fidelity bond issued by Great American. Graziano was an employee of the insured and was responsible for over-the-counter sales to customers. Graziano engaged in a scheme to give discounted prices to a trade association of Korean retailers. This scheme was not disclosed to his employer. The insured later suspected something amiss and hired an accountant to investigate. The accountant determined that \$775,000 in monies were missing. Criminal charges were commenced against Graziano. He pled guilty to grand larceny and paid a fine. Meanwhile, the insured made a claim on its fidelity bond. Great American paid the full amount of its policy. Graziano thereafter filed for bankruptcy. Great American did not file a proof of claim but instead commenced a non-discharge action, claiming that the debt was not dischargeable because it was based on embezzlement or larceny. In Re Graziano, 35 B.R. at 593. The action was based on a subrogation theory and, it appears, not an express assignment from the insured.

Graziano argued first that Great American could not recover because it had failed to file a proof of claim in the Bankruptcy proceeding. The Court rejected this argument, reasoning that a creditor's failure to file a proof of claim merely precluded the creditor from sharing in the

distribution of estate proceeds, but did not bar the creditor from pursuing a claim for non-discharge. See In Re Graziano, 35 B.R. at 593.

Great American argued that Graziano's plea of guilty to larceny precluded him from arguing that his conduct did not rise to the level of embezzlement or larceny under § 523. The Court disagreed and found that the criminal conviction did not preclude Graziano from litigating these issues in the context of the non-discharge action. Instead, the criminal conviction could be used as evidence by Great American, but would not be treated as conclusive evidence of larceny or embezzlement. The Court reasoned that *res judicata* (or claim preclusion) did not apply. With respect to collateral estoppel (or issue preclusion) the court held that four criteria must be established before invocation of collateral estoppel:

- (1) the issue sought to be precluded must be the same as that involved in the prior action;
- (2) that issue must have been actually litigated;
- (3) it must have been determined by a valid and final judgment; and
- (4) the determination must have been essential to the prior judgment.

In Re Graziano, 35 B.R. at 595-56.

The Court found that there had been no actual litigation of any issue in the criminal proceeding. The Court reasoned that, since Graziano's guilty plea was entered at his arraignment, the state had never presented its case. As such, no issues had been actually litigated in the prior criminal case. In Re Graziano, 35 B.R. at 595-56.

The Court then considered Great American's claim on its merits. With respect to claims of larceny or embezzlement under § 523(a)(4), the Court noted that Great American had a heavy burden. Specifically, it was required to prove its claim by "clear and convincing evidence". In Re Graziano, 35 B.R. at 593. The Court relied upon federal common law to define the elements of larceny and embezzlement. Larceny "is defined as the fraudulent and wrongful taking and carrying away the property of another with intent to convert such property to the taker's use without the consent of the owner." Id. at 594. In contrast, embezzlement is "the fraudulent appropriation of property by a person to whom such property has been entrusted or into whose hands it has lawfully come." Id. Thus, larceny differs from embezzlement only with respect to the manner in which the funds or property come into the party's possession – larceny contemplates a wrongful taking of property, while embezzlement contemplates wrongful appropriation of property which was originally in the rightful possession of the perpetrator. Id. The Court then considered the evidence and concluded that Great American had in fact proven embezzlement by Graziano, and entered a judgment finding that the debt was not-dischargeable. Id. at 596.

A fidelity insurer was held to be entitled to a non-dischargeable debt against a dishonest employee in In Re Hutcherson, 50 B.R. 845 (Bankr. E.D.Va. 1985). In this case the fidelity insurer, National Union, had issued a crime policy in favor of its insured, Robertshaw Controls Company. Hutcherson admitted that he had embezzled \$147,307 from Robertshaw. Hutcherson also plead guilty charges in connection with the embezzlement.

Robertshaw asserted a claim against National Union on its crime policy. This policy had a \$50,000 deductible. National Union paid Robertshaw \$97,307, reflecting the total loss less

the deductible. In exchange for the payment, National Union received from Robertshaw an assignment of Robertshaw's claims against Hutcherson. In addition, the policy expressly provided that National Union would be subrogated to Robertshaw's rights of recovery against any person. In Re Hutcherson, 50 B.R. at 847.

Hutcherson thereafter filed a Chapter 7 bankruptcy petition. He listed National Union as a creditor in his schedules. National Union thereafter commenced an adversary proceeding alleging that the debt was not dischargeable under 11 U.S.C. § 523(a)(4) as a debt for embezzlement or larceny. Hutcherson stipulated that he had stolen the money but claimed that National Union could not pursue a non-discharge action because National Union was not a direct party to the embezzlement. Hutcherson argued that only his former employer could pursue the claim, and that a subrogating insurer lacks standing under the bankruptcy code to pursue a non-discharge action. Hutcherson reasoned that a claim of nondischargeability "is personal to the party from whom the property was embezzled and the right to assert a dischargeability complaint cannot be maintained by a subrogated insurer who has made payment on the claim." In Re Hutcherson, 50 B.R. at 850.

The Court rejected Hutcherson's arguments and concluded that National Union had standing to pursue a claim for non-discharge. The Court relied largely on Virginia state court caselaw for the proposition that a subrogated insurer stands in the shoes of its insured for the purpose of pursuing claims which the insured would have had against third parties, including – in this case – Robertshaw's claim of non-dischargeable debt against its former employee. In Re Hutcherson, 50 B.R. at 852.

In In Re Shinew, 33 B.R. 588 (Bankr. N.D. Ohio 1983), the debtor was a former employee of a newspaper. The debtor engaged in a scheme of misappropriating in excess of \$10,000, such funds representing the proceeds of contests which had been offered by the newspaper to its readers. The debtor pled guilty to grand theft in connection with the scheme. The newspaper made a claim against its fidelity insurer, Great American. Great American paid the newspaper \$10,000 (its limit of coverage). The fidelity policy provided that, upon payment, Great American would be subrogated to the newspaper's rights of recovery against third parties. In Re Shinew, 33 B.R. at 590.

The debtor thereafter filed a Chapter 7 bankruptcy petition, and listed Great American as a scheduled debtor. Great American and the newspaper thereafter commenced non-discharge actions against the debtor. Great American claimed that the debt was non-dischargeable under 11 U.S.C. § 523(a)(4) as embezzlement, larceny or fraud while acting as a fiduciary. The Court held that the evidence supported a non-dischargeable judgment in favor of Great American based on theories of either larceny or embezzlement. The Court relied upon the fact that the debtor had admitted misconduct in connection with the contest, and further relied upon the debtor's guilty plea. In Re Shinew, 33 B.R. at 592.

Claims By Commercial Sureties

There are a number of reported cases addressing claims by commercial sureties pursuing claims objecting to discharge. Many of the cases involve claims by sureties on probate or fiduciary bonds where the debtor was the principal on the bond.

A surety for a sheriff pursued a claim for non-dischargeability against its principal in Western Surety Company v. Rich, 141 F.Supp. 872 (W.D.Ok. 1956). In this case the surety issued a bond for the benefit of Rich as sheriff. Rich committed an assault and battery against one Reynolds. Reynolds sued Rich and the surety in Oklahoma state court, and obtained a judgment against both defendants. The surety paid the judgment and thereafter brought an action against Rich in Oklahoma federal court. In response to this action, Rich claimed that any debt owed in connection with the claim had been discharged as a result of a bankruptcy proceeding in which the surety's debt had been scheduled and discharged. Rich also claimed that he was not liable on the underlying debt. The district court rejected Rich's claim and awarded the surety a judgment in the amount of its loss. The court rejected Rich's attempt to re-litigate the underlying claim, finding that the prior state court judgment was final and estopped Rich from disputing these allegations. The court further held that Rich's debt was non-dischargeable because the debt was based on a willful and unlawful assault committed by Rich. The court rejected the claim that the surety's payment of the claim took the debt outside of the categories of claims specifically exempted from discharge. See Western Surety Company v. Rich, 141 F.Supp. at 873.

A surety on a trustee's bond successfully pursued a non-discharge case against its principal in In Re Richardson, 178 B.R..19 (Bankr. D.C. 1995) aff'd 193 B.R. 378 (D.C. 1995) aff'd 107 F.3d 923 (D.C.Cir. 1997) cert denied 1997 U.S. Lexis 5207 (hereinafter "Richardson"). This case is especially useful to the extent that it highlights the issue of the surety's standing and the potentially significant distinction between the surety's claim for reimbursement and its claims based on subrogation.

In Richardson, the surety (Old Republic) issued a bond guaranteeing the principal's (Richardson) obligations as trustee. Specifically, Richardson had been appointed trustee by the Superior Court for the District of Columbia for the purpose of selling certain properties and placing the proceeds of the property into a trust account for distribution to beneficiaries. As a condition to his appointment, Richardson secured a bond from Old Republic. Richardson sold the properties but failed to deposit and secure all of the proceeds of the sale. Instead, Richardson paid most of the monies to himself, under the erroneous belief that he was entitled to these monies as compensation for his services. When Richardson failed to comply with a court order to return the money, judgment entered against Richardson and Old Republic. As surety Old Republic satisfied the judgment by paying the balance of monies due into the account. In Re Richardson, 178 B.R.. at 21.

Richardson thereafter filed a Chapter 7 bankruptcy petition. Old Republic filed a proof of claim with the bankruptcy court. Its proof of claim stated explicitly that its claim was based on subrogation and that, in this capacity, it was asserting the claim as subrogee of the trust beneficiaries. Old Republic also commenced an action against Richardson seeking a determination that Richardson owed a non-dischargeable debt to Old Republic. This complaint was based on the claim that the debt was for fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny under 11 U.S.C. § 523(a)(4). Old Republic's complaint, like its proof of claim, asserted claims sounding in subrogation based on the rights of the trust beneficiaries. No direct claim for reimbursement was asserted by Old Republic.

Richardson raised the following defenses to Old Republic's claim: (1) Old Republic could not proceed with a claim for subrogation because it chose to proceed with a claim for reimbursement; (2) Old Republic could not proceed with a claim for subrogation because it

could not show the existence of a fiduciary relationship between Old Republic and the debtor (Richardson); and (3) even if Old Republic could proceed with a claim of subrogation, it could not prove a defalcation because Richardson was at most guilty of negligence in connection with his administration of the estate. The Bankruptcy Court (and the District and Circuit Courts on appeal) rejected each of these arguments. In Re Richardson, 178 B.R. 19 (Bankr. D.C. 1995) aff'd 193 B.R. 378 (D.C. 1995) aff'd 107 F.3d 923 (D.C.Cir. 1997) cert denied 1997 U.S. Lexis 5207.

With respect to Old Republic's standing as subrogee, the District Court noted that Bankruptcy Code § 509(a) specifically recognizes the concept of subrogation for sureties. This section provides:

§ 509. Claims of codebtors

(a) Except as provided in subsection (b) or (c) of this section, an entity that is liable with the debtor on, or that has secured, a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment.

(b) Such entity is not subrogated to the rights of such creditor to the extent that--
(1) a claim of such entity for reimbursement or contribution on account of such payment of such creditor's claim is--

(A) allowed under section 502 of this title [11 USCS § 502];

(B) disallowed other than under section 502(e) of this title [11 USCS § 502(e)]; or

(C) subordinated under section 510 of this title [11 USCS § 510]; or

(2) as between the debtor and such entity, such entity received the consideration for the claim held by such creditor.

(c) The court shall subordinate to the claim of a creditor and for the benefit of such creditor an allowed claim, by way of subrogation under this section, or for reimbursement or contribution, of an entity that is liable with the debtor on, or that has secured, such creditor's claim, until such creditor's claim is paid in full, either through payments under this title or otherwise.

Section 509(b) provides that a surety's subrogation rights will not be recognized where it has an allowed claim for reimbursement or contribution against the debtor. This rule exists to prevent double recovery by the surety. In addition, subrogation will not be permitted where the subrogee (i.e. the surety) received the consideration for the original claimant's claim. Richardson argued that Old Republic had forfeited its subrogation rights by asserting a claim for reimbursement against Richardson. The District Court rejected this argument, noting that both Old Republic's proof of claim and its non-discharge complaint asserted claims sounding in subrogation and not reimbursement. See Richardson, 193 B.R. 378. The Bankruptcy Court also concluded that Old Republic was entitled to assert claims as the subrogee of the beneficiaries because it did not pay the claim as a volunteer but rather as an obligor under the state court judgment.

Richardson next claimed that Old Republic could prove a non-dischargeable debt for fraud or defalcation under 11 U.S.C. § 523(a)(4) only by demonstrating that a fiduciary

relationship existed directly between Old Republic and Richardson. The Bankruptcy Court rejected this argument. It reasoned that subrogation, at its essence, requires a determination as to whether a fiduciary relationship existed between Richardson and the beneficiaries, and not between Richardson and Old Republic. Moreover, Richardson's claim would subvert the policy of the bankruptcy code's exceptions to discharge, since a debtor could defeat a claim for nondischarge in every case simply by allowing the surety to pay the claim and then filing a bankruptcy petition. See Richardson, 178 B.R. at 23.

Having concluded that Old Republic was subrogated to the beneficiary's claims against Richardson, the Bankruptcy Court next determined that Old Republic was entitled to summary judgment on its claim that Richardson's debt to the beneficiaries was one for defalcation in a fiduciary capacity. The Bankruptcy Court concluded that Old Republic was entitled to summary judgment, and the District Court (and Circuit Court of Appeals) thereafter affirmed this determination. In response to Old Republic's Motion, Richardson (an attorney) argued that he was at most guilty of negligence, in that he mistakenly believed that the law allowed him to pay himself the proceeds of the sales as his fee. The Bankruptcy Court rejected this argument, concluding that "negligent ignorance of the law is not a defense to defalcation." Richardson, 178 B.R. at 26-7. In reaching the conclusion, the Bankruptcy Court considered whether "defalcation" requires "culpable conduct", i.e. fraudulent intent. The Bankruptcy Court concluded that an intentional unauthorized transfer of funds constituted a defalcation, even if the debtor was acting under a mistake of law. The Bankruptcy Court left open the possibility that a debtor acting merely negligently or with some mistake of fact will could be entitled to discharge. Richardson, 178 B.R. at 32-3.

A probate bond surety secured a non-dischargeable judgment against its principal in In Re Swanson, 231 B.R. 145 (D.N.H. 1999). Here, Peerless Insurance Company issued a bond guaranteeing the obligations of Swanson as guardian of an estate. The Probate Court issued a decree finding that the principal had breached her fiduciary obligations by failing to account for assets in the amount of at least \$65,000. Peerless satisfied its obligations under the bond and thereafter pursued the principal for repayment. The principal filed for bankruptcy. Peerless commenced an action seeking a non-dischargeable judgment against the principal under 11 U.S.C. § 523(a)(4). Specifically, Peerless claimed that the principal's debt was for defalcation arising out of a fiduciary duty. Peerless moved for summary judgment on this claim. The Bankruptcy Court concluded that Peerless was entitled to summary judgment on its claim. The Court held first that a court appointed guardian constitutes a fiduciary under § 523(a)(4), and that the Probate Court decree appointing the principal was sufficient evidence to support this determination. The Court further reasoned that "defalcation" under § 523(a)(4) "includes innocent as well as intentional or negligent default so as to reach the conduct of all fiduciaries who are short in their accounts." In Re Swanson, 231 B.R. 145 citing Peerless Insurance Co. v. Misiaszek, 162 B.R. 80, 82 (Bankr. D.N.H. 1993). The Court concluded that no genuine dispute existed as to the principal's having committed a defalcation of the estate funds. In reaching this conclusion, the Court relied upon the Probate Court decree which found that the principal had breached her obligations as guardian, reasoning that collateral estoppel applied and precluded the re-litigation of any facts determined by the Probate Court.

In In Re Daly, 247 B.R. 369 (Bankr. S.D.N.Y. 2000) a probate bond surety secured summary judgment on its claim for nondischargeable debt under 11 U.S.C. § 523(a)(4). Here the principal/debtor (an attorney) was appointed personal representative of a probate estate by the Michigan Probate Court. Western Surety issued a surety bond guaranteeing his

performance as fiduciary. The Probate Court issued a decree finding that the principal had improperly engaged in self-dealing in the estate and also ordered that certain funds be returned to the estate. The principal failed to comply. Western Surety paid on its bond and thereafter obtained a judgment for indemnification from the Probate Court. In Re Daly, 247 B.R. at 373. The principal filed a Chapter 7 petition and, in response, Western Surety filed an action seeking a determination of non-dischargeability under § 523(a)(4). On cross motions for summary judgment, the Bankruptcy Court concluded that Western Surety was entitled to judgment as a matter of law.

The principal argued that Western Surety could not prevail since there was no fiduciary relationship between Western Surety and the principal. The Court rejected this argument. Relying upon In Re Richardson, 178 B.R. 19 (Bankr. D.C. 1995) aff'd 193 B.R. 378 (D.C. 1995) aff'd 107 F.3d 923 (D.C.Cir. 1997) cert denied 1997 U.S. Lexis 5207, the Court reasoned that subrogation allowed the surety to prove its claim based on the fiduciary relationship which existed between the principal and the probate estate. In Re Daly, 247 B.R. at 378-79.

Next, the Court considered the standard of proof required for a claim of defalcation under § 523(a)(4). While the Court concluded that defalcation under § 523(a)(4) requires proof of more than mere negligence, it did not set forth a clear definition. In Re Daly, 247 B.R. at 380. Both parties argued that the Michigan Probate Court decrees should be afforded collateral estoppel effect. As such, the Bankruptcy Court analyzed the Probate Court decrees and determined that there were sufficient findings to conclude that the principal had engaged in conduct that rose above mere negligence in connection with the estate. This conduct included self dealing and actions which directly violated the Probate Court's orders. Id. at 381. Based on this evidence, the Bankruptcy Court concluded that Western Surety was entitled to summary judgment on its claim that the principal had breached his fiduciary obligations.

In In Re Yanke, 225 B.R. 428 (D.Minn. 1998), the principal was appointed guardian by the Minnesota Probate Court. The surety provided a bond guaranteeing the principal's performance of his obligations. The principal was removed and the successor guardian thereafter pursued a claim against the principal and the surety in probate court. The probate court, after an evidentiary hearing, ruled against the principal and found that the principal had breached his fiduciary obligations by failing to account for estate assets. The Court held that the principal and the surety were obligated to reimburse the estate for \$179,682. After an unsuccessful appeal, the surety paid the probate court judgment in exchange for a release. This release ran in favor of the surety only and did not mention the principal. In Re Yanke, 225 B.R. at 432.

The principal thereafter filed for bankruptcy. The surety commenced an action for non-discharge under 11 U.S.C. § 523(a)(4). On cross motions for summary judgment, the Bankruptcy Court first rejected the principal's argument that § 523(a)(4) requires a fiduciary relationship between the surety and the principal. Instead, under its subrogation rights, the surety is entitled to rely upon the fiduciary relationship which existed between the principal and the estate. The Court also rejected the principal's claim that the surety's payment of the judgment to the estate extinguished the surety's subrogation rights. The principal claimed that the estate's execution of a release precluded any subrogation claim by the surety. The Court rejected this argument, reasoning that the release did not apply to the claims against the principal. Next, the Court concluded that the decision and findings of the Minnesota Probate

Court would be accorded collateral estoppel effect. Applying collateral estoppel principles of Minnesota state law, the Court reasoned that the principal had a full and fair opportunity to litigate the breach of fiduciary duty issues in the prior probate court proceeding. Thus the Minnesota probate court decree was accorded full collateral estoppel effect and precluded the principal from re-litigating whether his actions were a breach of his fiduciary obligations.

A surety on a guardianship bond pursued a non-discharge complaint against its principals in In Re Barnes, 317 B.R. 187 (Bankr. M.D.Ga. 2004). In this case the principals were appointed guardians of the estate of their daughter, who had received a substantial settlement of a medical malpractice claim. The principals used the settlement monies to open a hardware store. The store eventually failed, thereby depleting the assets of the estate. The principals were removed as guardians during a proceeding conducted by the clerk of the court. A successor guardian was appointed and thereafter made a claim against the bond. The surety paid under the bond and took an assignment of the estate's claims against the principals. The principals filed a Chapter 7 petition. The surety filed a complaint objecting to discharge under § 523(a)(4), claiming that the debt arose from the defalcation of the principals while acting in a fiduciary capacity. The surety moved for summary judgment on this claim.

In considering the surety's summary judgment motion, the Court first considered whether the principals had acted in a fiduciary capacity in their role as guardians. On this issue, the Court concluded that the existence of a fiduciary relationship was a question of state law, and the law of North Carolina recognized guardians as fiduciaries:

For purposes of section 523(a)(4), the definition of "fiduciary" is narrowly construed, meaning that the applicable state law that creates a fiduciary relationship must clearly outline the fiduciary duties and identify the trust property; if state law does not clearly and expressly impose trust-like obligations on a party, the court will not assume that such duties exist and will not find that there was a fiduciary relationship.... Certain relationships are generally recognized as involving fiduciary obligations within the meaning of section 523(a)(4). Guardians . . . have been held to be acting in a fiduciary capacity within the meaning of this provision.

In Re Barnes, 317 B.R. at 190-91 quoting 4 Collier on Bankruptcy P 523.10[1][c] (15th ed. Rev. 2004).

Next, the Court considered whether the debt was for a defalcation under § 523(a)(4). The Court set forth the general rule that defalcation did not require proof of fraud:

Defalcation refers to a failure to produce funds entrusted to a fiduciary. However, the precise meaning of "defalcation" for purposes of § 523(a)(4) has never been entirely clear. An early, and perhaps the best, analysis of this question is that of Judge Learned Hand in *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2nd Cir. 1937). Judge Hand concluded that while a purely innocent mistake by the fiduciary may be dischargeable, a "defalcation" for purposes of this statute does not have to rise to the level of "fraud," "embezzlement," or even "misappropriation." Some cases have read the term even more broadly, stating

that even a purely innocent party can be deemed to have committed a defalcation for purposes of § 523(a)(4)...

Since debts arising from breaches of ordinary care are normally dischargeable in bankruptcy, and exceptions to discharge are strictly construed in favor of the debtor, some degree of culpability is required to make a debt nondischargeable as a defalcation under section 523(a)(4). However, when a debtor has been acting as a trustee or other fiduciary, the debtor is responsible for knowledge of the fiduciary responsibilities and may not cite mere ignorance as a defense to an objection to dischargeability asserted under section 523(a)(4).

In Re Barnes, 317 B.R. at 190-91 quoting 4 Collier on Bankruptcy P 523.10[1][b] (15th ed. Rev. 2004) and Quaif v. Johnson, 4 F.3d 950, 955 (11th Cir. 1993). .

The Court concluded that a genuine issue of material fact existed as to whether the defendants had been guilty of a defalcation. The Court rejected the surety's claim that the state court clerk's removal of the principals should be given res judicata or collateral estoppel effect. While the Court recognized that a determination of the clerk could, in the appropriate case, have preclusive effect, it concluded that the clerk in this case did not consider whether the principals had committed a defalcation. In Re Barnes, 317 B.R. at 193.

Finally, the Court considered whether the surety had standing to assert the non-discharge claim against the principals. The Court concluded that the surety had standing pursuant to its subrogation rights and also pursuant to the assignment which it received from the successor guardian. In Re Barnes, 317 B.R. at 193.

Practical Considerations – Weighing The Risks and Rewards

A fidelity insurer or commercial surety considering these issues must weigh the risks against the possible rewards of pursuing a non-discharge complaint. At its essence, the decision is largely driven by economics. The primary risk is that the costs will far outweigh any recovery. At the end of the day, the insurer or surety may have spent a lot of money to secure an uncollectible judgment. While this risk is always present in salvage analysis, it is especially relevant in bankruptcy since the defendant in bankruptcy is presumptively insolvent.

However, the rewards of securing a non-dischargeable judgment can be significant. A non-dischargeable judgment gives the surety or fidelity insurer substantial leverage. The debtor cannot escape the judgment and the insurer can make full use of post-judgment remedies such as liens, garnishments and executions to collect on it. The surety or insurer's position can be especially strong since most or all of the other debts of the debtors have been discharged. Thus, the surety or insurer can literally step to the front of the line for the purpose of pursuing the debtor.

In weighing its options, the commercial surety and fidelity insurer should consider the following:

- The bankruptcy courts are not level playing fields. The rules are designed to favor the debtor and to encourage discharge. Even so, most bankruptcy judges will give you a fair hearing and do not want to reward fraud or theft by a debtor.

- The deadline for filing a complaint will be strictly enforced by the bankruptcy court. If you have actual notice of the bankruptcy filing, you will be bound by the deadline (even if you were not sent formal notice by the debtor).
- You may be required to re-litigate issues which were addressed in earlier litigation with the debtor. Bankruptcy courts are reluctant to accord full res judicata or collateral estoppel effect to non-bankruptcy judgments. This may be the case even if the prior judgment was in a criminal case against the debtor.
- The fact that you (or your insured) secured a judgment against the debtor previously does not mean that you can prove a non-dischargeable debt under the Code. The elements of a non-discharge action are different and the burden of proof is higher.

Conclusion

For the fidelity insurer and commercial surety, a bankruptcy filing by a principal or by a dishonest employee is a significant event. Objecting to discharge is an option which should be considered in any case. Apart from the costs, the commercial surety and fidelity insurer must evaluate the likelihood of success as well as the prospects for recovering on the judgment.

GARY M. CASE is a member of the firm Wolf, Horowitz, Etlinger & Case LLC in Hartford, Connecticut. His practice focuses on surety, fidelity, construction, insurance coverage and subrogation. He received his undergraduate degree from Fairfield University (B. S., cum laude 1988). He received his J. D. from the University of Connecticut School of Law (J. D. with high honors, 1991), and an L. L. M. in Insurance Law from the University of Connecticut School of Law in 2003. He has also served as an Adjunct Instructor of Law at the University of Connecticut School of Law (Moot Court and Lawyering Process Programs).

Gary has presented numerous papers concerning surety and fidelity law. He was a contributing author to the "Law and Practice of Insurance Coverage Litigation," West Group & ABA Tort and Insurance Practice Section 2000, and the "The Law of Payment Bonds," American Bar Association, Tort and Insurance Practice Section. 1998. In 2004 Gary presented a paper on surety defenses at the ABA's "Back to Basics" program in Hartford, Connecticut. In 2006, at the ABA's Fidelity & Surety Law Committee's Mid-Winter Meeting, Gary co-presented "Whose Claim Is It Anyway? Allocation of Fidelity Exposures Among Multiple Carriers and Multiple Policies – Theory and Practice."

Gary has also been a contributing author to the following recent ABA publications: "Performance Bond Manual" (Lawrence Lerner and Theodore Baum, Editors) (2006); "The Law of Motor Vehicle Dealer Bonds" (William Downing, Lisa Jennings-Baroun, James Kreamer and Aaron McKee, Editors) (2006); and "Contractor's State License Bonds Desk Reference" (Edward Lodgen, Catherine Squillace and Mark Herbert, Editors) (2006).

He can be reached by phone at 860-724-6667, or by email at gcase@wolfhorowitz.com.

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