

# **NINETEENTH ANNUAL NORTHEAST SURETY AND FIDELITY CLAIMS CONFERENCE**

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## **THE FIGHT OVER DISCHARGE AND DISCHARGEABILITY – WHY IT MATTERS**

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## **The Fight Over Discharge and Dischargeability – Why it Matters**

### **I. Difference Between Discharge and Dischargeable Debt**

#### **A. OVERVIEW**

The purpose of the bankruptcy laws is to provide the honest individual debtor with a “fresh start” by discharging most, if not all, of the debtor’s debts. Generally, a bankruptcy discharge releases a debtor from all unsecured debts that exist when the bankruptcy case is filed. The order granting a discharge is a permanent order prohibiting the creditors of the debtor from taking any form of collection action on discharged debts.

Creditors are afforded the right to either object to the debtor’s discharge in its entirety under 11 U.S.C. § 727, or to the discharge of their particular debt under 11 U.S. C. §§ 523 and 1328. Frequently the showing required to obtain a judgment of non-dischargeability of a particular debt may also support the entry of a judgment denying the debtor’s discharge in its entirety.

Section 727 of the Bankruptcy Code governs a debtor’s eligibility for discharge in chapter 7 (“Liquidation”) cases. A debtor who is not an individual (i.e. a corporation, partnership, limited liability company) is not granted a discharge in chapter 7. Section 1141 governs discharge of a chapter 11 (“Reorganization”) debtor and provides for application of the exceptions to discharge enumerated in section 727 to discharge in a chapter 11 case if the debtor is not an individual, the confirmed plan provides for the liquidation of all or substantially all of the property of the estate, and the debtor does not engage in business after consummation of the plan. Section 1328 contains the discharge provisions applicable to chapter 13 (“Wage Earner”) plans. Section 523, on the other hand, governs dischargeability of individual enumerated categories of debts.

While some exceptions to the discharge of particular debts are self-executing, objecting to the debtor’s entire discharge requires the commencement and prosecution of a complaint under Rule 4004 of the Federal Rules of Bankruptcy Procedure. Similarly, the grounds on which a surety or fidelity insurer can typically object to the dischargeability of its particular debt will require the commencement of an adversary proceeding under Rule 4007 of the Federal Rules of Bankruptcy Procedure.

**PRACTICE POINT: From the perspective of a surety and/or the issuer of a fidelity policy, its litigation dollars are generally better spent in obtaining the denial of the discharge of its particular debt, rather than seeking the overall denial of a debtor’s discharge. This is true because a successful objection to discharge will result in all debts surviving the bankruptcy, whereas a successful objection to the dischargeability of a particular debt will result in the debtor’s post-petition assets being subject to collection only by the individual creditor, rather than the creditor body as a whole.**

The time limitations for commencing an adversary proceeding objecting to the discharge of a chapter 7 debtor under §727 and/or for filing a complaint objecting to the discharge of a particular debt under § 523 (a)(2), (4) and (6) is relatively short - sixty (60) days after the date

set for the first meeting of creditors.<sup>1</sup> The 2005 Amendments to the Bankruptcy Code have narrowed the discharge available to chapter 13 debtors. Creditors may now object to the dischargeability of a particular debt under §§ 523(a)(2) and 523(a)(4) in a Wage Earner case. Proposed interim rules set forth the same time limitations for commencing an action against a chapter 13 debtor to determine a particular debt non-dischargeable under §§ 523(a)(2) and 523(a)(4) as for chapter 7 debtors.<sup>2</sup> In a chapter 11 case, however, a complaint objecting to the debtor's discharge can be filed at any time prior to the commencement of the first date set for the hearing on confirmation of the debtor's plan.<sup>3</sup> In each instance, the creditor bears the burden of proof by a preponderance of the evidence.<sup>4</sup>

**PRACTICE POINT: Even if you do not plan to attend the first meeting of creditors, make sure to calendar the date of the first meeting since critical dates for filing objections to discharge and/or dischargeability will expire 60 days thereafter. Motions to request an extension of the filing deadlines must be filed prior to the expiration of the original deadline.**<sup>5</sup>

## B. OBJECTING TO THE DISCHARGE IN ITS ENTIRETY

Section 727(a) mandates that a court grant a chapter 7 debtor a discharge unless such a debtor is disqualified from the granting of a discharge under one or more of the specified disqualifications listed in § 727(a). Section 727(a) provides, in relevant part, that a court will not grant the debtor a discharge when:

- (1) the debtor is not an individual;
- (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; or
  - (B) property of the estate, after the date of the filing of the petition;
- (3) the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's

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<sup>1</sup> See Fed. R. Bankr. P. 4004(a), Fed. R. Bankr. P. 4007(c).

<sup>2</sup> Interim Fed.R. Bankr. P. 4007(d).

<sup>3</sup> See Fed. R. Bankr. P. 4004(a).

<sup>4</sup> Grogan v. Garner, 498 U.S. 279 (1991).

<sup>5</sup> Id. at 291, Fed. R. Bankr. P. 4007 (c)

financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case;

(4) the debtor knowingly and fraudulently, in or in connection with the case—

(A) made a false oath or account;

(B) presented or used a false claim;

(C) gave, offered, received, or attempted to obtain money, property, or advantage, or a promise of money, property, or advantage, for acting or forbearing to act; or

(D) withheld from an officer of the estate entitled to possession under this title, any recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs;

(5) the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor's liabilities;

(6) the debtor has refused, in the case—

(A) to obey any lawful order of the court, other than an order to respond to a material question or to testify;

(B) on the ground of privilege against self-incrimination, to respond to a material question approved by the court or to testify, after the debtor has been granted immunity with respect to the matter concerning which such privilege was invoked; or

(C) on a ground other than the properly invoked privilege against self-incrimination, to respond to a material question approved by the court or to testify;

(7) the debtor has committed any act specified in paragraph (2), (3), (4), or (6) of this subsection, on or within one year before the date of the filing the petition, or during the case, in connection with another case, under this title or under the Bankruptcy Act, concerning an insider;

(8) the debtor has been granted a discharge under this section, under section 1141 of this title, or under section 14, 371, or 476 of the Bankruptcy Act, in a case commenced within 8 years before the date of the filing of the petition;

(9) the debtor has been granted a discharge under section 1228 or 1328 of this title, or under section 660 or 661 of the Bankruptcy Act, in a case commenced within six years before the date of the filing of the petition, unless payments under the plan in such case totaled at least-

(A) 100 percent of the allowed unsecured claims in such case;

or

(B)

(i) 70 percent of such claims; and

(ii) the plan was proposed by the debtor in good faith, and was the debtor's best effort;

(10) the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter;

(11) after filing the petition, the debtor failed to complete an instructional course concerning personal financial management described in section 111, except that this paragraph shall not apply with respect to a debtor who is a person described in section 109(h)(4) or who resides in a district for which the United States trustee (or the bankruptcy administrator, if any) determines that the approved instructional courses are not adequate to service the additional individuals who would otherwise be required to complete such instructional courses under this section (The United States trustee (or the bankruptcy administrator, if any) who makes a determination described in this paragraph shall review such determination no later than 1 year after the date of such determination, and not less frequently than annually thereafter); or

(12) the court after notice and a hearing held not more than 10 days before the date of the entry of the order granting the discharge finds that there is reasonable cause to believe that-

(A) section 522 (q)(1) may be applicable to the debtor; and

(B) there is pending any proceeding in which the debtor may be found guilty of a felony of the kind described in section 522(q)(1)(A) or liable for a debt of the kind described in section 522(q)(1)(B).

11 U.S.C. § 727(a)(1)-(a)(12).

## 1. Denial of Discharge under § 727(a)(2)(A) - Fraudulent Transfers

The purpose of § 727(a)(2) is to “prevent the discharge of a debtor who attempts to avoid payment to creditors by concealing or otherwise disposing of assets.”<sup>6</sup>

To prove a fraudulent transfer or concealment of property, a creditor must show: (1) the debtor or an agent of the debtor transferred, removed, destroyed, or concealed property of the debtor within one year before the date of the filing of the petition; and (2) with the intention to hinder, delay or defraud a creditor.<sup>7</sup> The burden of proof rests on the person objecting to discharge.<sup>8</sup> Once sufficient evidence is presented by the movant, the burden thereafter shifts to the debtor to provide evidence in rebuttal to the movant’s *prima facie* case.<sup>9</sup> However, the movant still bears the ultimate burden of persuasion by proving all of the essential elements necessary to bar a discharge by clear and convincing evidence.<sup>10</sup>

As noted above, to deny a discharge to a debtor under § 727(a)(2)(A), the debtor must have acted with intent to hinder.<sup>11</sup> Absent actual intent to defraud a creditor, a discharge will not be denied. To determine if a debtor acted with fraudulent intent, courts generally look at the totality of the circumstances because it is rarely susceptible to direct proof.<sup>12</sup> To infer actual intent to defraud, courts have looked for “badges of fraud” such as: “(1) a lack of adequate consideration; (2) the family, friendship or close associate relationship between the parties; (3) the retention of possession, benefit or use of the property in question; (4) the party’s financial condition sought to be charged both before and after the transaction in question; (5) the existence or cumulative effect of a pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors; and (6) the general chronology of the events and transactions under inquiry.”<sup>13</sup> (Emphasis added)

Concealment of property or assets may be accomplished by the transfer of legal title to a third party coupled with the retention of benefits of ownership.<sup>14</sup> A transfer that occurs more than one year prior to the petition may still warrant the denial of a discharge if the transfer is concealed or beneficial interests are continued into the one year time period.<sup>15</sup>

## 2. Denial of Discharge under § 727(a)(4)(A) - False Oath or Account

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<sup>6</sup> Collier on Bankruptcy, § 727.02 at 727-13 (15<sup>th</sup> Ed. Rev. 2001).

<sup>7</sup> In re Silverstein, 151 B.R. 657 (Bankr. E.D.N.Y. 1993); In re Halperin, 215 B.R. 321 (Bankr. E.D.N.Y. 1997).

<sup>8</sup> In re Delancey, 58 B.R. 762, 766 (Bankr. S.D.N.Y. 1986).

<sup>9</sup> Id.

<sup>10</sup> In re Shapiro, 59 B.R. 844, 847 (Bankr. E.D.N.Y. 1986); In re Delancey, 58 B.R. at 770; In re Switzer, 55 B.R. 991, 999 (Bankr. S.D.N.Y. 1986).

<sup>11</sup> In re Cohen, 142 B.R. 720, 722 (Bankr. E.D. Pa. 1992).

<sup>12</sup> In re Sapphire, 139 F.2d 34, 35 (2d Cir. 1985).

<sup>13</sup> In re Kaiser, 722 F.2d 1574, 1582-83 (2d Cir. 1983); In re Sawyer, 130 B.R. 384, 395 (Bankr. E.D.N.Y. 1991).

<sup>14</sup> In re Portnoy, 201 B.R. 685, 692 (Bankr. S.D.N.Y. 2007).

<sup>15</sup> In re Palermo, 370 B.R. 599, 612 (Bankr. S.D.N.Y. 2007).

Section 727(a)(4)(A) of the Bankruptcy Code is intended to insure that “adequate information is available to those interested in the administration of the bankruptcy estate without the need for examination or investigation to determine whether the information provided is true.”<sup>16</sup> Under this section, “the debtor must have made a statement under oath which the debtor knew to be false, and the debtor must have made the statement willfully, with the intent to defraud” to be denied a discharge.<sup>17</sup> The false oath must be related to a material matter.<sup>18</sup> Whether a debtor has made a false oath is a question of fact.<sup>19</sup>

When objecting to discharge under § 727(a)(4)(A), the creditor must prove: “(1) the debtor made a statement under oath; (2) the statement was false; (3) the debtor knew the statement was false; (4) the debtor made the statement with fraudulent intent; and (5) the statement related materially to the bankruptcy case.”<sup>20</sup> The burden of proof on an objection to discharge is on the movant and each element must be established by a preponderance of the evidence.<sup>21</sup>

Fraudulent intent must be shown by actual, not constructive fraud.<sup>22</sup> The party objecting to the discharge must show that the information was omitted for the specific purpose to defraud and “not simply because the debtor was careless or failed to fully understand his attorney’s instructions.”<sup>23</sup> Nonetheless, a reckless indifference to the truth is sufficient to sustain an action for fraud.<sup>24</sup>

**PRACTICE POINT: A false oath that is sufficient to deny a discharge may be written or oral - i.e. a false statement or omission in the debtor’s schedules or a false statement under oral examination during the bankruptcy case. This ground also constitutes a bankruptcy crime under section 152 of title 18, United States Code for which the penalty is a fine, imprisonment for not more than five years, or both.**

### ***3. Denial of Discharge under § 727(a)(4)(D) - Withholding Records***

A discharge may be denied under § 727(a)(4)(D), where a debtor knowingly and fraudulently “withheld from an officer of the estate entitled to possession under this title, any recorded information, including books, documents, records, and papers relating to the debtor’s property of financial affairs.”<sup>25</sup> To establish grounds for denial of discharge under this section,

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<sup>16</sup> In re Dubrowsky, 244 B.R. 560, 572 (E.D.N.Y. 2000).

<sup>17</sup> Williamson v. Fireman’s Fund Ins. Co., 828 F.2d 249, 251 (4th Cir. 1987).

<sup>18</sup> Id.

<sup>19</sup> Id.

<sup>20</sup> Id.

<sup>21</sup> Id.

<sup>22</sup> In re Kelly, 135 B.R. 459, 461 (Bankr. S.D.N.Y. 1992).

<sup>23</sup> Id.

<sup>24</sup> In re Bren, 303 B.R. 610 (B.A.P. 8<sup>th</sup> Cir. 2004); In re Mazzola, 4B.R. 179 (Bankr. D. Mass. 1980) (Citing In re Diorio, 407 F.2d 1330, 1331 (2d Cir. 1969)).

<sup>25</sup> 11 U.S.C.A. § 727(a)(4)(D).

the objecting party must show that the debtor withheld the information “knowingly and fraudulently.”<sup>26</sup>

While actual intent is required, such intent may be established through circumstantial evidence or inferred from the debtor’s conduct.<sup>27</sup> Courts have found the requisite intent to act “knowingly and fraudulently” was present where the debtor’s conduct was evasive or persistently uncooperative.<sup>28</sup>

#### **4. Denial of Discharge under § 727(a)(5) - Loss of Assets**

If a debtor has failed to explain satisfactorily any loss of assets or deficiency of assets that could have been used to satisfy his or her debts, the debtor will be denied a discharge under §727(a)(5).<sup>29</sup> This section is intended to deter those who attempt to abuse the bankruptcy process “by obfuscating the true nature of [their] affairs, and then refusing to provide a credible explanation.”<sup>30</sup>

In order to obtain a denial of discharge, the creditor need not prove that the debtor acted knowingly or fraudulently in dissipating assets.<sup>31</sup> Rather, the creditor must only establish a loss or deficiency of assets.<sup>32</sup> Once the creditor produces some evidence of the disappearance of substantial assets or unusual transactions, the burden shifts to the debtor to offer a satisfactory explanation of what happened to the assets. The debtor must convince the bankruptcy judge that the assets were not hidden or improperly shielded.<sup>33</sup> If the debtor’s explanation is convincing and not rebutted, there may be no need for documentary corroboration.<sup>34</sup> It is within the court’s discretion to determine what constitutes a “satisfactory” explanation for the loss of assets.<sup>35</sup>

#### **5. Objectionable Conduct in Title 11 Case of an Insider - § 727 (a)(7)**

Where, within one year of the filing of the debtor’s own petition, a debtor has committed any of the previously enumerated acts in connection with another bankruptcy case in which the debtor is an insider, the debtor’s discharge in his own case may be denied. Accordingly, objectionable conduct in a substantially contemporaneous related case involving a relative, a

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<sup>26</sup> Farouki v. Emirates Bank Int’l Ltd., 14 F.3d 244, 249 (4th Cir. 1994).

<sup>27</sup> In re Young, 346 B.R. 597, 615 (Bankr. E.D.N.Y. 2006).

<sup>28</sup> Id.

<sup>29</sup> 11 U.S.C.A. § 727(a)(5).

<sup>30</sup> In re Gannon, 173 B.R. 313, 317 (Bankr. S.D.N.Y. 1994).

<sup>31</sup> In re Ryan, 285 B.R. 624, 632 (Bankr. W.D. Pa. 2002).

<sup>32</sup> In re Cacioli, 463 F.3d 229, 238-39 (2d Cir. 2006) (citing In re McGovern, 215 B.R. 304, 307 (Bankr. D. Conn. 1997)).

<sup>33</sup> In re Bodenstein, 168 B.R. 23, 33 (Bankr. E.D.N.Y. 994).

<sup>34</sup> See In re Cromer, 214 B.R. 86, 97 (Bankr. E.D.N.Y. 1997) (stating that “as long as debtor’s explanation convinces the judge that the debtor has not hidden or shielded assets, corroborating evidence by way of documentation is not necessary in every instance”).

<sup>35</sup> In re Jacobs, 381 B.R. 147, 168 (Bankr. E.D. Pa. 2008) (citing In re Mezvinsky, 265 B.R. 681, 689 (Bankr. E.D. Pa. 2001)).

partnership in which the debtor is a partner, or a corporation in which the debtor is an officer, director, or controlling person, can be grounds for the denial of a discharge.

#### **6. Denial of Discharge Based upon Receipt of Prior Discharge - § 727(a)(8)**

As a result of the 2005 Amendments, the time-frame for granting a discharge in a second bankruptcy case has been extended from six (6) to eight (8) years. Debtors who have been granted a discharge under chapter 7 or chapter 11 within eight (8) years before the date of filing the current bankruptcy petition will be denied a discharge. Nonetheless, the prohibition against obtaining a second discharge, will not prevent the filing of a second petition within the eight year time-frame, nor will it prevent the debtor from taking advantage of the exemption and lien avoidance powers provided by the Bankruptcy Code.<sup>36</sup>

#### **C. REVOCATION OF DISCHARGE – SECTION 727(E).**

Under section 727(e) a trustee, a creditor or the United States trustee may bring an action to revoke a debtor's discharge if one of three conditions exist. (1) The discharge was obtained by fraud and the party seeking revocation of the discharge did not know of the fraud until after the discharge was granted. (2) The debtor acquired property that is property of the estate or became entitled to acquire property that would be property of the estate, and knowingly and fraudulently failed to report the acquisition or entitlement to the property, or to deliver or surrender the property to the trustee. (3) The debtor refused to obey an order of the court, other than an order to respond to a material question or to testify upon the proper invocation of the right of self-incrimination.

If the ground for revocation is fraud, the action must be brought within one year after the discharge is granted. If on other grounds, the action must be brought before the later of one year after the discharge is entered or the date the case is closed. 11 U.S.C. § 727(e). Section 727(d)(1) specifically requires that the party seeking revocation based on fraud not learn of the fraud until after entry of discharge.

#### **D. OBJECTION TO THE DISCHARGE OF A PARTICULAR DEBT**

Many of the categories of debt which are excepted from discharge under section 523 do not require the filing of any intervening complaint for the debt to survive the bankruptcy filing, i.e.: most federal and state taxes, domestic support obligations, criminal and civil fines owed to governmental entities, governmentally insured student and health education loans, restitution orders, and debts arising from death or personal injury caused by the unlawful operation of a motor vehicle. Nonetheless, the category of debts for which a surety and the issuer of a fidelity policy will typically object to discharge require proof by a preponderance of evidence in the context of an adversary proceeding commenced against the debtor.

#### **1. Denial of Discharge under § 523(A)(2) – False Pretenses, False Representation or Actual Fraud**

Under § 523(a)(2) a debt for money or an extension, renewal or refinancing of credit is non-dischargeable to the extent it is obtained by false pretenses, a false representation or

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<sup>36</sup> Collier on Bankruptcy, §727.11 at 727-55 (15th Ed. Rev. 2001).

actual fraud. The dischargeability of claims based upon false representations made by the debtor fall within two categories: (i) false representations other than a statement respecting financial condition, § 523(a)(2)(A); and (ii) false statements in writing relating to financial condition, § 523(a)(2)(B).<sup>37</sup>

#### **a. Representations not Relating to Financial Condition**

Section 523(a)(2)(A) prevents the discharge of all liabilities for money, property, services, or an extension, renewal or refinancing of credit arising from false pretenses, a false representation or actual fraud, other than a statement respecting the debtor's or an insider's financial condition. It does not cover misrepresentations dealing with a debtor's or an insider's financial condition. "The purposes of [§ 523(a)(2)(A)] are to prevent a debtor from retaining the benefits of property obtained by fraudulent means and to ensure that the relief intended for honest debtors does not go to dishonest debtors."<sup>38</sup>

The elements for false representation, false pretenses and actual fraud<sup>39</sup> are: (i) a knowingly false representation or one made in reckless disregard of the truth; (ii) intention to deceive; (iii) intention to induce the creditor to rely upon the false statement; (iv) actual and justifiable reliance upon the misrepresentation by the creditor; and (v) damages.<sup>40</sup> A false representation of the kind required in order to except a debt from discharge involves an express fraudulent misrepresentation by the debtor.<sup>41</sup>

The basic elements of wrongdoing inherent in fraud need not be proven to establish a claim of non-dischargeability for debts incurred by "false pretenses" or "false representation."<sup>42</sup> Absent a duty imposed by law to disclose facts, as in the case where a fiduciary relationship exist or where the debtor has willfully concealed or omitted material facts, mere silence and failure to disclose do not establish a false representation.<sup>43</sup>

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<sup>37</sup> See Cohen v. De la Cruz, 523 U.S. 213, 218 (1998).

<sup>38</sup> Collier on Bankruptcy, ¶ 523.08[1][a], at 523-44.7 (2005); see also Cohen v. De La Cruz, 523 U.S. 213, 221 (1998) (holding that the fraud exception to discharge contained in § 523(a)(2)(A) "prohibit[s] the discharge of any liability arising from a debtor's fraudulent acquisition of money, property, etc., including an award of treble damages for the fraud.").

<sup>39</sup> Reckless representation is not sufficient to except the debt from discharge for actual fraud. To constitute actual fraud, debtor's conduct or representation must be actual or positive fraud rather than fraud implied by law. Collier on Bankruptcy, ¶ 523.08[1][d] at 523-45.

<sup>40</sup> Field v. Mans, 516 U.S. 59 (1995); In re Mercer, 246 F.3d 391, 403 (5th Cir. 2001); Glen McCrory & Ann McCrory v. Robert T. Spigel ( In re Spigel ), 260 F.3d 27, 32 (1st Cir. 2001); In re Cohn, 54 F.3d 1108 (3d Cir. 1995); Cooke v. Cooke (In re Cooke), 335 B.R. 269, 274-75 (Bankr. D. Conn. 2005).

<sup>41</sup> In re Menna, 16 F.3d 7, 30 (1<sup>st</sup> Cir. 1994).

<sup>42</sup> Carpenter v. United States, 484 U.S. 19, 27 (1987) (false pretenses do not require proof of (1) a representation which is (2) false, as in classic fraud, it requires that the debtor engaged in conduct "wronging one in his property rights by dishonest methods or schemes [such as] deprivation of something of value by trick, deceit, chicane or overreaching.").

<sup>43</sup> In re Harmon, 250 F.3d 1240, 1247 (9<sup>th</sup> Cir. 2001) ("A debtor's failure to disclose material facts constitutes a fraudulent omission under § 523(a)(2)(A) if the debtor was under a duty to disclose and the debtor's omission was motivated by an intent to deceive."); Citibank (S.D.), N.A. v. Eashai (In re Eashai), 87 F.3d 1082, 1089 (9th Cir. 1996) (same); Wolstein v. Docteroff (In re Docteroff), 133 F.3d 210, 216 (3d Cir. 1997) (A debtor's

## **b. Fraud Relating to Financial Condition**

Pursuant to 11 U.S.C. § 523(a)(2)(B), liabilities incurred for money, property, services, or an extension, renewal or refinancing of credit is not dischargeable to the extent such liabilities are obtained by the use of a statement --

- (i) in writing;
- (ii) that is materially false;
- (iii) respecting the debtor's or an insider's financial condition;
- (iv) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
- (v) that the debtor caused to be made or published with intent to deceive.

11 U.S.C. §523(a)(2)(B). Each of the elements under § 523(a)(2)(B) must be established by a preponderance of the evidence.<sup>44</sup>

The writing requirement is critical. Oral statements relating to financial condition do not form the basis for an objection to discharge under § 523(a)(2)(B).<sup>45</sup> For the statement respecting the debtor's or an insider's financial condition to be in writing, it must have been written and signed by the debtor, or the writing must have been adopted and used, or caused to be prepared, by the debtor.<sup>46</sup>

A statement will be deemed materially false if it contains "an important or substantial untruth" that would affect the creditor's decision to extend credit, had the debtor's true financial condition been known.<sup>47</sup> False information supplied as an inducement for the surety to issue bonds has resulted in the debt being held non-dischargeable under §523 (a)(2)(B).<sup>48</sup> Similarly, where a financial guaranty bond was procured based upon a materially false written statement of the investor's financial condition, the court inferred an intent to deceive, and held the indemnification obligation to the surety not dischargeable.<sup>49</sup> Concealment, omission or understatement of liabilities generally constitutes a material false statement.<sup>50</sup> In addition,

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silence regarding information that he is obligated to disclose can constitute a false misrepresentation actionable under 11 U.S.C. § 523(a)(2)(A)).

<sup>44</sup> Grogan v. Garner, 498 U.S. 279, 281 (1991); In re Graham, 973 F.2d 1089 (3d Cir. 1992).

<sup>45</sup> Engler v. Van Steinburg, 744 F.2d 1060 (4th Cir. 1984) (oral statement that property not subject to liens insufficient).

<sup>46</sup> Collier on Bankruptcy, ¶ 523.08[5], at 523-46; see also, In re Gonzalez, 287 F. Supp. 281 (S.D.N.Y. 1968).

<sup>47</sup> Ins. Co. of N. Am. v. Cohn (In re Cohn), 54 F.3d 1108, 1114 (3d Cir. 1995).

<sup>48</sup> In re Adams, 312 B.R. 576 (Bankr. M.D. N.C. 2004)

<sup>49</sup> Young v. National Union Fire Ins. Co. of Pittsburgh, PA, 995 F.2d 547 (5<sup>th</sup> Cir. 1993)

<sup>50</sup> First Nat'l City Bank v. Latona, 260 F.2d 264 (2d Cir. 1958); In re Poskanzer, 143 B.R. 991 (Bankr. D.N.J. 1992).

financial documents containing false claims of ownership of real property are generally held to be materially false statements under § 523(a)(2)(B), as they “paint [ ] a substantially untruthful picture of a financial condition by misrepresenting information of the type which would normally affect the decision to grant credit.”<sup>51</sup>

Reasonable reliance under this subsection requires more than the intermediate level of “justifiable reliance.” Courts make a determination of reasonableness based upon the totality of circumstances.<sup>52</sup>

**PRACTICE POINT: It is important, especially during the underwriting process, to make sure that financial information upon which the surety and/or the issuer of a fidelity policy intends to rely is current information. Remember, also, that the Surety typically has the right to obtain financial information from its Principal and Indemnitors pursuant to the General Agreement of Indemnity. You may request such information in the course of handling a claim and/or when considering providing financial assistance to the Principal. If such information contained in a financial statement is updated by the principal, it is essential that the updated information be submitted in writing and signed. In the event the Principal or Indemnitors subsequently file for bankruptcy protection, you should compare the financial information with any subsequently discovered information to see whether there were any material misrepresentation or omissions. Further, it may be necessary, in order to satisfy the test of “reasonable reliance” to perform simple investigations like UCC searches – especially if the financial information submitted reflects that assets are owned “free and clear.” Also note that where an indemnitor raises the defense that his/her signature on the General Agreement of Indemnity is a forgery – the silence of other indemnitors who should know whether the signature is genuine, can rise to the level of fraud/false pretenses as against those who remained silent.**

**(2) *Denial of Discharge under § 523(A)(4) – For Fraud or Defalcation While Acting in a Fiduciary Capacity, Embezzlement or Larceny,***

Section 523(a)(4) excepts from discharge any liability arising from a debtor’s (i) fraud or defalcation while acting in a fiduciary capacity and (ii) embezzlement or larceny.<sup>53</sup>

**a. *Fraud or Defalcation by Fiduciary***

To prove that a debt is non-dischargeable under § 523(a)(4), a creditor must prove the debtor committed (i) fraud or defalcation, (ii) while acting in a fiduciary capacity, and (iii) the

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<sup>51</sup> In re Green, 355 B.R. 302, 308 (Bankr. E.D. Okla. 2006).

<sup>52</sup> First Nat’l Bank v. Pontow, 111 F.3d 604, 610 (8th Cir. 1997). Some courts require the creditor to show that it engaged in further investigation of the written financial statement of the debtor. Kentile Floors, Inc. v. Winham, 440 F.2d 1128 (9th Cir. Ariz. 1971) (creditor “acted unreasonably if it acted upon the . . . statement in extending credit without any further investigation.”); see also In re Smith, 424 F. Supp. 858 (M.D. La. 1976); Sweet v. Ritter Finance Co., 263 F. Supp. 540 (W.D. Va. 1967).

<sup>53</sup> 11 U.S.C. § 523(a)(4).

existence of an express trust.<sup>54</sup> Some courts have defined “defalcation” to encompass embezzlement or misappropriation of trust funds by a fiduciary, as well as the “failure to properly account for such funds.”<sup>55</sup> Other courts, however, have defined defalcation as the failure of a fiduciary to produce funds entrusted to him or her, whether or not the fiduciary’s actions reach the level of fraud, embezzlement or misappropriation.<sup>56</sup>

Whether a debtor will be considered a “fiduciary” for purposes of § 523(a)(4), is a matter of federal bankruptcy law. In accordance with the historic predilection of bankruptcy courts to narrowly construe exceptions to discharge,<sup>57</sup> they have held that section 523(a)(4) applies only to express or technical trusts, not to constructive trusts or implied trusts.<sup>58</sup> An express trust may arise from contract, from statute, or may be inferred from conduct. In some instances, courts have required an identifiable trust corpus entrusted to the fiduciary.<sup>59</sup> In the event, however, the bankruptcy court determines that an express trust has been created, personal liability which is not dischargeable will result if the debtor has misappropriated trust assets.

### **i. Express Trust Created by Statute**

Many state legislatures have enacted construction trust fund statutes to safeguard against contractor and subcontractor misappropriation of construction funds. Generally, the construction trust fund statutes declare that project funds, such as construction loan proceeds received by an owner of a project, or monies paid by the owner to a general contractor, as well as monies paid by a contractor to a subcontractor, are trust assets held by them as trustees to be used for payment of all claims due or to become due for labor and materials used on the project.<sup>60</sup> Where these statutes have been found by bankruptcy courts to create express trusts, the debtor who invades the trust corpus and misapplies the payments to uses not permitted by the statute, commits a breach of fiduciary duty and is personally liable for “defalcation while acting in a fiduciary capacity.”<sup>61</sup> Those who violate these construction trust

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<sup>54</sup> Otto v. Niles (In re Niles), 106 F.3d 1456, 1459 (9th Cir. 1997); Pahlavi v. Ansari (In re Ansari), 113 F.3d 17, 20 (4th Cir. 1997); Zohlman v. Zoldan (In re Zoldan), 226 B.R. 767, 772 (S.D.N.Y. 1998); Maciolek v. Firer (In re Firer), 317 B.R. 457, 465-66 (Bankr. D. Conn. 2004).

<sup>55</sup> Capitol Indemnity Corp. v. Interstate Agency, Inc. (In re Interstate Agency), 760 F.2d 121, 125 (6th Cir. 1985); Niles, 106 F.3d at 1460.

<sup>56</sup> Lewis v. Scott (In re Scott), 97 F.3d 1182, 1186 (9th Cir. 1996) (defalcation includes the innocent default of a fiduciary who fails to account fully for money received.); Quaif v. Johnson, 4 F.3d 950 (11th Cir. 1993); In re Moreno, 892 F.2d 417 (5th Cir. 1990) (defalcation does not require an intentional conduct and may simply be a willful neglect of duty). But compare, Adamo v. Scheller (In re Scheller), 265 B.R. 39, 53 (Bankr. S.D.N.Y. 2001), (“[w]hile something more than mere negligence by a fiduciary is required, a defalcation need not rise to the level of fraud, embezzlement, or misappropriation.”).

<sup>57</sup> Matter of Pratt General Contractors, Inc., 142 B.R. 47, 49 (Bankr. D. Conn. 1992);

<sup>58</sup> In re Wong, 291 B.R. 266, 278 (Bankr. S.D.N.Y. 2003) (constructive trusts or trusts *ex malificio* do not satisfy this element of § 523(a)(4), trust must exist before and apart from the circumstances giving rise to the contested debt); Zoldan, 226 B.R. at 772; In re Paley, 8 B.R. 466, 469 (Bankr. E.D.N.Y. 1981).

<sup>59</sup> Evans v. Pollard (In re Evans), 161 B.R. 474 (9th Cir. 1992) (breach of general fiduciary obligations are insufficient and claim must involve money or property entrusted to the fiduciary).

<sup>60</sup> See, Md. Code Ann., Real Property § 9-201(b)(1).

<sup>61</sup> In re Gonzales, 22 B.R. 58 (Bankr. 9th Cir. Cal. 1982) (misapplying construction funds is defalcation under § 523(a)(4) of the Bankruptcy Code); In re Siegfried, 5 Fed.Appx. 856, \*3 (10<sup>th</sup> Cir. 2001) (“Colorado

fund statutes may be subject to personal, as well as criminal, liability.<sup>62</sup> Even where a trust fund statute permits commingling of contract payments that makes tracing of specific trust fund assets difficult, some bankruptcy courts have held the diversion of funds for purposes not *permitted by the statute constitutes a defalcation while acting in a fiduciary capacity.*<sup>63</sup>

**PRACTICE POINT:** Investigate whether the relevant jurisdiction has enacted construction trust fund statutes, and if so whether these statutes have been held to create an express trust which can be used to support a complaint for non-dischargeability. If litigation has been commenced prior to a bankruptcy filing, it is important to include counts in the complaint not only for indemnification (breach of contract), but also for defalcation while acting in a fiduciary capacity (breach of trust). A judgment of liability for breach of trust should have preclusive effect in a subsequent bankruptcy. **Note:** Although most statutes are directed to corporate liability of businesses in relation to trust funds received, a breach of a trust fund statute can usually be traced to the individuals in control, who will be held personally responsible for his or her own tortuous acts or breaches of fiduciary duty.<sup>64</sup>

### *ii. Express Trust Created by Contract*

Even without a trust fund construction statute, the General Agreement of Indemnity has been held to create an express contractual trust as between the indemnitor and the surety where the indemnitor is a trustee of funds paid under bonded contracts.<sup>65</sup> Diversion of those trust funds is deemed a defalcation while acting in a fiduciary capacity sufficient to bar the indemnitors' discharge under § 523 (a)(4) of the Bankruptcy Code.<sup>66</sup> Defalcation does not

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construction lien statute creates an express or technical trust, as required for a fiduciary relationship to exist under § 523 of the Bankruptcy Code precluding discharge of debt for fraud or defalcation as a fiduciary.”)

<sup>62</sup> See, e.g., N.Y. Lien Law, §§ 77-79A (imposing both civil and criminal liabilities); Ga Code Ann. § 16-8-15 (2003) (criminal sanctions); 42 Oka. St. Ann. §§ 152-153 (2005) (civil sanctions). Some states' construction trust fund statutes provide for personal liability for officers or directors of the contractor if the trust funds are misappropriated, where the officer or director has control over distribution of the trust funds. See, e.g., *In re McGee*, 258 B.R. 139, 143 (Bankr. M.D. Md. 2001) (holding that “controlling officer of corporation was personally liable under Maryland Construction Trust Statute for failing to see that trust funds earmarked for payment of subcontractors' and materialmen's claims were in fact distributed to them); *Pan-Western Life Ins. Co. v. Galbreath (In re Galbreath)*, 112 B.R. 892 (Bankr. S.D. Ohio 1990) (corporate director was a fiduciary and his debt was non-dischargeable); *Stetson Ridge Associates, Ltd. V. Walker*, 325 B.R. 598 (D. Colo. 2005)(co-owner of subcontractor who controlled cash management of business liable under Colorado trust fund statute and debt non-dischargeable); *Reliance Ins. Co. v. Lott Group, Inc.*, 370 N.J. Super. 563 (App.Div. 2004) (NJ appellate court held consultant personally liable to surety for assisting contractor to divert funds from bonded jobs to account controlled by consultant in violation of NJ trust fund statute).

<sup>63</sup> *In re Barnes*, 377 B.R. 289 ( Bankr. D. Colo. 2007)

<sup>64</sup> *In re Valerino Construction, Inc.* 250 B.R. 39,44 (Bankr. W.D. N.Y. 2000)

<sup>65</sup> *In re Herndon*, 277 B.R. 765 (E.D. Ark. 2002)

<sup>66</sup> *In re McCormick*, 283 B.R. 680 (Bankr. W.D. Pa. 2002) (holding that clause in indemnity agreement executed by debtor-contractor in favor of bond surety, where by debtor agreed that any funds received on bonded project would be held in trust for payment of subcontractors and materialmen until bond was completely discharge, was sufficient to create express or technical trust under Pennsylvania law, of the kind required under § 523 of the Bankruptcy Code); *Wright v. Gulf Ins. Co. (In re Wright)*, 266 B.R. 848, 852 (Bankr. E.D. Ark. 2001) (determining that debt to surety was non-dischargeable for defalcation based on express trust in indemnity

require a showing of fraud. Rather, defalcation merely means the “failure to meet an obligation, misappropriation of trust funds or money held in any fiduciary capacity, and failure to properly account for such funds” Blacks Law Dictionary (6<sup>th</sup> Ed.) at 417. Similarly, in the fidelity context, the indemnity obligation to the surety has been held non-dischargeable where the debtor stole from the estate for which he was the personal representative.<sup>67</sup>

**PRACTICE POINT: When commencing a non-dischargeability action, it is not unusual for the debtor’s first line of defense to be a challenge of the validity of the underlying debt. Other defenses may include the defense that the individual was not responsible for the actions taken, and/or was not in control. If the surety had arranged for the defaulted principal to complete construction with the surety’s assistance, and the surety had given the principal access to contract balances, blame will be placed on the surety for the misappropriation of the contract funds. To avoid such a situation, the surety should consider putting into place an independent restructuring officer to oversee funds management.**

### ***b. Embezzlement or Larceny***

Under § 523(a)(4), all acts of embezzlement and larceny are exempted from discharge whether or not the debtor was acting in a fiduciary capacity.<sup>68</sup> The question of what constitutes embezzlement and larceny within the meaning of § 523(a)(4) is a question of federal law.<sup>69</sup> Embezzlement is defined under federal common law as “fraudulent appropriation of property by a person to whom such property has been entrusted or into whose hands it has lawfully come.”<sup>70</sup> Proof of embezzlement requires the creditor to show that the debtor appropriated property for a use other than that for which it was entrusted, and the circumstances indicate fraud.

Larceny, on the other hand, occurs when the original taking of the property was unlawful. For purposes of denial of dischargeability of the debt, larceny is defined as “the fraudulent and wrongful taking and carrying away of the property of another with intent to convert such property to the taker’s use without the consent of the owner.”<sup>71</sup>

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agreement); Gillespi v. Jenkins (In re Jenkins, 110 B.R. 74, 76-77 (Bankr. M.D. Fla. 1990) (same); In re Marrs-Winn Co., Inc., 103 F.3d 584, 592 (7th Cir. 1996) (holding that subcontract between the contractor and the debtor-subcontractor created a valid express trust under Missouri law, entitling materialmen and laborers specified in the trust agreement to funds as such funds were not property of the debtor-subcontractor’s estate); Federal Ins. Co. v. Fifth Third Bank, 867 F.2d 330, 333 (6th Cir. 1989) (bond instrument and construction contract created express trust under Ohio law that surety could enforce).

<sup>67</sup> In re Stevens, 322 B.R. 132 (Bankr. E.D. Mo. 2005).

<sup>68</sup> Brady v. McAllister (In re Brady), 101 F.3d 1165, 1172-73 (6th Cir. 1996); In re Noblit, 327 B.R. 307, 310 (Bankr. E.D. Mich 2005).

<sup>69</sup> Collier on Bankruptcy, ¶ 523.10[2] at 523-76 (15<sup>th</sup> Ed. Rev. 2001)

<sup>70</sup> Id.; In re Brady, *supra* at 1172-1173, (quoting Moore v. United States, 160 U.S. 268 (1895)); Adamo v. Scheller ( In re Scheller ), 265 B.R. 39, 53 (Bankr. S.D.N.Y. 2001) and J.C. Faw v. Wiles (In re Wiles), 166 B.R. 975, 980 (Bankr. M.D. Fla. 1994) (the creditor must show evidence of fraud or fraudulent intent).

<sup>71</sup> In re Graziano, 35 B.R. 589, 594 (Bankr. E.D.N.Y. 1983).

**PRACTICE POINT: Objections to dischargeability on the basis of embezzlement and/or larceny are more apt to apply to the issuer of a fidelity bond, based upon its rights of subrogation. The debtor's plea of guilty to the criminal act, however, may not necessarily have a preclusive effect under the doctrines of res judicata and collateral estoppel for the purposes of determining dischargeability of the debt. The fidelity insurer may still be confronted with the cost of a trial in bankruptcy court, as the underlying factual issues have not been litigated where a plea is entered.**

## **II- Why The Objection to Discharge/Dischargeability Matters**

The reality is that many debtors whose debts are not discharged find a way to manage to never have assets appear in their names and, therefore, sometimes there is significant concern on the part of the sureties about spending money in connection with litigation over the dischargeability of an indemnitor's liability to the surety because of the fear that it may not be cost-effective to do so. Apart from whether or not such litigation will ultimately succeed, however, in situations where you have legitimate concern that the debtor may have engaged in fraud or other bases to support a non-discharge claim, reminding the indemnitors of their responsibility to the surety and the potential for the surety pursuing a non-dischargeability claim in bankruptcy can often be useful when dealing with recalcitrant indemnitors.

Specifically, indemnitors sometimes will attempt not only to avoid indemnity obligations, but also may threaten the surety with heightened losses by virtue of their lack of cooperation unless the surety does not voluntarily relinquish its indemnity rights. When indemnitors seek to avoid their obligations in this fashion based upon the threat that they will simply file for bankruptcy protection in the event the surety does not relinquish its contractual rights, it is often useful to alert indemnitors of those actions that might have given rise to a non-dischargeable obligation to the surety.

As previously noted, both state construction trust fund statutes and contractual provisions in the indemnity agreement create fiduciary obligations on the part of the officers of the company in favor of the surety. A failing or failed contractor often will not have properly observed its fiduciary obligations and may have diverted trust funds to non-trust purposes. Moreover, it is not unusual to find that indemnitors whose financial statements looked pretty good just a short while ago when they were seeking to secure surety credit, all of a sudden look quite different as they are preparing to file for bankruptcy protection. Reminding the indemnitors in applicable situations of the consequences of their willful misrepresentation of their financial condition in connection with securing surety credit and the potential impact upon the dischargeability of their obligations under the indemnity agreement may be necessary and appropriate to protect the surety's rights and mitigate its loss. The surety's willingness to overlook certain financial misrepresentations and trust fund diversions may depend upon the cooperation received from indemnitors and their willingness to nonetheless help the surety mitigate its loss.

## **CONCLUSION**

For the construction surety, the decision to proceed with a complaint objecting to the discharge of a debtor, or the dischargeability of a particular debt, will ultimately rest upon a cost/benefit analysis to limit the surety's bond exposure. The surety should consider the status

of the bonded projects at the petition date, whether the debtor's assistance in the completion of pending projects is a viable alternative, the potential for increased exposure to the owner, sub-contractors, materialmen and suppliers in the event there is no cooperation from the debtor/indemnitor, as well as the status of claims already paid. Although state construction trust fund statutes may assist the surety in obtaining a judgment that will survive bankruptcy, the assistance of the debtor in completing bonded projects, and reviewing and reducing bond claims may be a more valuable alternative than a judgment which may never be collectible.

The fidelity bond issuer, on the other hand, by virtue of its rights of subrogation will generally have a claim against the debtor which is non-dischargeable. The cost/benefit analysis in this instance differs from that of the construction surety. Here the issues to be considered are the cost and expense of pursuing litigation against the potential that in the future the debtor will come into funds to repay the non-discharged debt.

## APPENDIX

### Review of Select State Construction/Lien Statutes<sup>72</sup>

#### a. **Connecticut**

Connecticut does not have a construction trust fund statute. However, courts in Connecticut have held that Connecticut's mechanic's lien law, Conn. Gen. Stat. §§ 49-33 through 49-36, entitles general contractors and subcontractors to a constructive trust on funds from owners, and such funds are excluded from property of the estate under § 541(b)(1) of the Bankruptcy Code.<sup>73</sup> If a mechanic's lien is not properly obtained, however, the constructive trust is not imposed on monies received or due from the property owner.<sup>74</sup>

#### b. **Florida**

Like Connecticut, Florida does not have a construction trust fund statute, except with respect to insurance proceeds received by a owner or lienor of real property based on damages done to such real property by fire or other casualty.<sup>75</sup> Nonetheless, § 713.346 (mechanic's lien statute), provides several rights to subcontractors, materialmen and suppliers performing work on private projects, including the right to seek an accounting and file a complaint. Section § 255.071 provides identical remedies to subcontractors, materialmen, and suppliers performing work on public projects. Section 255.05(2)(a)(2) requires persons not in privity with the general contractor to serve a written notice of intent, commonly known as a Notice to Contractor, to look to the bond.

In the bankruptcy context, courts have held that section 713.345 of Florida Statute, West's F.S.A. § 713.345, which makes it a crime to misapply funds obtained for purpose of improving real property and mandates that such funds must be applied to amounts due and owing for services, labor or materials used for improvement of the real property, does not

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<sup>72</sup> For a more complete survey of state construction fund statutes see: Carney, Robert F., "Payment Provisions in Construction Contracts and Construction Trust Fund Statutes: A Fifty State Survey, "Fifteenth Annual Northeast Surety and Fidelity Claims Conference," Sept. 2004.

<sup>73</sup> Matter of Pratt General Contractors, Inc., 142 B.R. 47, 49 (Bankr. D. Conn. 1992);

<sup>74</sup> Id.

<sup>75</sup> See West's F.S.A. § 713.32. Specifically, § 713.32, which applies only to private projects, provides, in pertinent part, that:

The proceeds of any insurance that by the terms of the policy contract are payable to the owner of improved real property or a lienor and actually received or to be received by him or her because of the damage, destruction, or removal by fire or other casualty of an improvement on which lienors have furnished labor or services or materials shall, after the owner or lienor, as the case may be, has been reimbursed therefrom for any premiums paid by him or her, be liable to liens or demands for payment provided by this part to the same extent and in the same manner, order of priority, and conditions as the real property or payments under a direct contract would have been, if the improvement had not been so damaged, destroyed, or removed. . . . The named insured who receives any proceeds of the policy shall be deemed a trustee of the proceeds, and the proceeds shall be deemed trust funds for the purposes designated by this section for a period of 1 year from the date of receipt of the proceeds. This section shall not apply to that part of the proceeds of any policy of insurance payable to a person, including a mortgagee, who holds a lien perfected before the recording of the notice of commencement or recommencement.

create a fiduciary relationship between a real property owner and the contractor as required under § 523(a)(4)).<sup>76</sup> Nonetheless, Florida courts have held that a debt to the surety was non-dischargeable for defalcation based on the express trust created in the indemnity agreement.<sup>77</sup>

c. **Maryland**

Maryland has a construction trust statute which requires contractors and subcontractors to hold in trust, for the benefit of unpaid subcontractors or sub-subcontractors who did the work or furnished the materials, funds paid under a construction contract by an owner and/or general contractor.<sup>78</sup> The Maryland construction trust law applies to both private and public construction projects, but not to federal projects within the state or single home residential contracts.<sup>79</sup>

Several cases have held that Maryland Construction Trust Statute does not create an express trust sufficient to deny dischargeability of a debt incurred by the debtor's breach of fiduciary duty under § 523 of the Bankruptcy Code because the statute does not require that funds be separately segregated.<sup>80</sup>

d. **Massachusetts**

Massachusetts does not have a construction trust fund statute, and no statutory provisions exist apart from the mechanic's lien provisions, M.G.L. c. 254, § 1 et. seq., which require contractors to pay in full all materialmen or subcontractors from funds they receive from an owner.

e. **New Jersey**

New Jersey has enacted two statutes that give subcontractors and suppliers a trust interest in funds that an owner pays to a contractor or a contractor to a supplier, N.J.S.A. § 2A:29A, et. seq. and N.J.S.A. § 2A:44-148.

N.J.S.A. § 2A:29A, et. seq. applies to private projects for the construction of a dwelling house and provides that monies paid as a deposit or advance by a person who has contracted or agreed to purchase a dwelling house to be constructed constitute trust funds in the hands of any person who receives those funds. Courts have held that § 2A:29A does not create an

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<sup>76</sup> In re Gropp, 153 B.R. 350, 352 (Bankr. M.D. Fla. 1993).

<sup>77</sup> Gillespi v. Jenkins (In re Jenkins), 110 BR 74, 76-77 (Bankr. M.D. Fla. 1990)

<sup>78</sup> See Md. Code Ann., Real Prop. §§ 9-201, et seq.

<sup>79</sup> Md. Code Ann., Real Prop. § 9-204.

<sup>80</sup> In re Halversen, 330 B.R. 291, 289 (Bankr. M.D. Fl 2005) (construing Maryland law and holding that Maryland Construction Trust Statute does not impose express or technical trust relationship on parties, of a kind required by § 523 for non-discharge of fiduciary fraud because the statute does not require contractor to segregate funds); see also In re Piercy, 140 B.R. 108, 114 (Bankr. D. Md. 1992); In re Holmes, 117 B.R. 848, 855 (Bankr. D. Md. 1990).

express trust sufficient to deny dischargeability of a debt incurred by the debtor's breach of fiduciary duty under § 523 of the Bankruptcy Code.<sup>81</sup>

N.J.S.A. § 2A:44-148, which applies to public project, provides that any monies paid by the state to a contractor pursuant to a contract for a public improvement constitute trust funds in the hands of the contractor until all claims for labor and materials are paid. The purpose of this statute is to ensure that public money is devoted to public purposes by impressing a trust upon that money until it achieves that purpose.<sup>82</sup> The trust applies only to monies that had actually been "paid" to a contractor and not to contract balances still in the possession of a state agency.<sup>83</sup> Sureties can assert the rights of subcontractors and/or materialmen under N.J.S.A. § 2A:44-148.<sup>84</sup>

f. **New York**

New York does have a construction trust fund statute, N.Y. Lien Law Art. 3-A, §§ 70-79a (McKinney 2007) ("New York Construction Trust Law"). Article 3-A of New York Construction Trust Law creates a statutory trust for certain funds paid to an owner, general contractor and subcontractor for the improvement of private and public real property.<sup>85</sup> The trust is automatically created once monies (trust assets) come into the possession of the trustee [owner, general contractor or subcontractor].<sup>86</sup> If trust assets are misappropriated, an officer and director of a corporation who is trustee under New York Construction Trust Law can be held personally liable for the misappropriation of the funds if such officer and director actively participated in the misappropriation.<sup>87</sup>

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<sup>81</sup> Matter of Rausch, 49 B.R. 562, 565 (Bankr. D.N.J. 1985) (holding that N.J.S.A. § 2A:29A-1, 2A:29A-3 providing that all monies paid as a deposit or advance by person who has contracted or agreed to purchase dwelling house to be constructed shall constitute trust funds and providing for bankruptcy of person receiving money deposited or advanced, did not make the debtor contractor a fiduciary within meaning of Bankruptcy Code excepting from discharge debt incurred by fraud or defalcation while acting in a fiduciary capacity in that relationship imposed by New Jersey statutes was not that of a technical trust).

<sup>82</sup> Reliance, 370 N.J. Super. 563 at 574; see also Universal Bonding Ins. Co. v. Gittens and Sprinkle Enterprises, Inc., 960 F.2d 366, 372-7 (3d Cir. 1992) (noting that while funds in the hands of the government are not trust funds, once debtor-contractor received such monies from the state it had to hold those monies subject to statutory trust imposed by § 2A:44-148 in favor of laborers and materialmen, and such funds could not be allocated to, or be distributed to, general creditors or used by contractor in its effort to reorganize).

<sup>83</sup> National Surety Corp. v. Barth, 11 N.J. 506, 95 A.2d 145, 147 (1953).

<sup>84</sup> Montefusco Excavating & Contracting Co., Inc. v. Middlesex County, 82 N.J. 519, 523, 414 A.2d 961, 963 (1980) (holding that where bond surety has paid contractor's indebtedness to laborer or materialmen, surety may, under § 2A:44-148, pursue remedies of laborer or materialmen by proceeding against funds paid to contractor).

<sup>85</sup> N.Y. Lien Law § 70; see also In re Silba, 170 B.R. 195, 200 (Bankr. E.D.N.Y. 1994) (holding that statutory trust was created under New York lien law once general contractor received improvement funds from owner).

<sup>86</sup> N.Y. Lien Law § 70(3).

<sup>87</sup> In re Kofsky, 351 B.R. 123, 129 (Bankr. S.D.N.Y. 2006) (finding corporate officer personally liable); In re Grosso, 9 B.R. 815, 825 (Bankr. N.D.N.Y. 1981) (noting that any person who knowingly causes misappropriation of trust assets by a corporation is personally liable for participation in the breach); Edgewater Const. Co., Inc., v. 81 & 3 of Watertown, Inc., 1 A.D.3d 1054, 1057, 769, N.Y.S.2d 343, \*3 (4<sup>th</sup> Dept. 2003) (same).

Misappropriation of trust assets constitutes larceny under New York Construction Trust Law.<sup>88</sup>

For purposes of dischargeability under § 523 of the Bankruptcy Code, courts have held that the trust created under New York Construction Trust Law constitutes an express trust that provides a basis to except debt from discharge based upon the debtor's fraud or defalcation while acting in a fiduciary capacity.<sup>89</sup>

In addition to having the Construction Trust Law, New York also has a mechanic's lien law, N.Y. Lien Law Art. 2 §§ 3-39-c ("New York Lien Law").

With respect to private projects New York Lien Law provides:

"[a] contractor, subcontractor, laborer, materialman . . . who performs labor or furnishes materials for the improvement of real property with the consent of or at the request of the owner thereof, or of his agent, contractor or subcontractor, and any trust fund to which benefits and wage supplements are due or payable for the benefit of such laborers, shall have a lien for the principal and interest, of the value, or the agreed price, of such labor, including benefits and wage supplements due or payable for the benefit of any laborer, or materials upon the real property improved or to be improved and upon such improvement, from the time of filing a notice of such lien..."<sup>90</sup>

Except for projects relating to a single family dwelling, "[n]otice of lien may be filed at anytime during the progress of the work and the furnishing of the materials, or, within eight months after the completion of the contract, or the final performance of the work, or the final furnishing of the materials, dating from the last item of work performed or materials furnished."<sup>91</sup> A properly filed mechanic's lien on a private project is valid for one year from the date of filing.<sup>92</sup> Privity with the owner or general contractor is not a prerequisite to lien rights.<sup>93</sup>

Section 5 of New York Lien Law governs improvements or construction on real property belonging to the state or a public corporation. Under this section, a person performing labor for or furnishing materials to a contractor or subcontractor who has a contract with the state for work on real property belonging to the state is granted a lien for such labor or material upon

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<sup>88</sup> N.Y. Lien law § 79-a; see also In re Valerino Construction, Inc., 250 B.R. 39, 44 (Bankr. W.D.N.Y. 2000) (noting that under New York law, any owner, contractor, or subcontractor, or responsible individual who misappropriates trust assets can be charged with larceny, is subject to t personal civil liability and such debt will be non-dischargeable in the event of a bankruptcy).

<sup>89</sup> In re Dobrayel, 287 B.R. 3, 19-20 (Bankr. S.D.N.Y. 2002) (*sua sponte* finding that debtor-contractor's debt to subcontractor was non-dischargeable under New York Construction Law and § 523(a)(4)).

<sup>90</sup> N.Y. Lien Law § 3.

<sup>91</sup> N.Y. Lien Law §10.

<sup>92</sup> N.Y. Lien Law § 17.

<sup>93</sup> Regal Lumber Co., Inc. v. Buck, 157 Misc.2d 376, 378, 596 N.Y.S.2d 1000, 1002 (County Ct. 1993)

the construction funds paid by the state, provided a notice of lien is properly filed.<sup>94</sup> The major difference between a private project lien and a public project lien in New York is that a private project lien gives the lienor an interest in the real property, whereas a lien on a public project gives the lienor a right to funds dedicated to that project.<sup>95</sup>

g. ***Pennsylvania***

Pennsylvania has no construction trust statute, but has held that the indemnity agreement creates an express trust under Pennsylvania law.<sup>96</sup>

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<sup>94</sup> N.Y. Lien Law § 5.

<sup>95</sup> Lincoln First Bank, N.A. v. Spaulding Bakeries Inc., 117 Misc.2d 892, 897, 459 N.Y.S.2d 696, 700 (Sup. Ct. 1983) (public lien attaches solely to funds of public corporation due under contract for improvement).

<sup>96</sup> In re McCormick, 283 B.R. 680 (Bankr. W.D. Pa. 2002) (holding that clause in indemnity agreement executed by debtor-contractor in favor of bond surety, where by debtor agreed that any funds received on bonded project would be held in trust for payment of subcontractors and materialmen until bond was completely discharge, was sufficient to create express or technical trust under Pennsylvania law, of the kind required under § 523 of the Bankruptcy Code).