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REVIEW OF BANKRUPTCY DISCHARGE PRINCIPLES AGAINST FIDELITY AND SURETY INDEMNITORS

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REVIEW OF BANKRUPTCY DISCHARGE PRINCIPLES
AGAINST FIDELITY AND SURETY INDEMNITORS

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REVIEW OF BANKRUPTCY DISCHARGE PRINCIPLES

I. Introduction.

After the presentation of this topic and paper two years ago at the Eighth Annual Southern Surety and Claims Association Conference, virtually all of our firm's fidelity and surety client representatives have asked for a personal copy of the original paper. This presentation is designed to update the principles and issues addressed in the original paper following basically the same format.

Every fidelity insurer and surety has the unfortunate experience of having a dishonest employee, defalcating fiduciary, or fraudulent personal indemnitor (herein sometimes referred to as "principals" or "debtors") try to escape the indemnity obligation by filing for protection under the United States Bankruptcy Code. The fidelity insurer's and surety's recovery efforts are not foreclosed by such evasive tactics. By employing some sound concepts in claims handling, the fidelity insurer and surety may be able to increase the chances of recovery (as opposed to limited recovery by other creditors) when these kinds of principals invoke federal bankruptcy jurisdiction and oversight.

This paper will briefly discuss some basic points for claim and salvage representatives and attorneys to keep in mind when these kinds of principals file for bankruptcy protection. First, the paper will address Chapter 7 liquidation cases and authorities which allow fidelity insurers/sureties to successfully object to the discharge of the indemnity obligation owed by dishonest employees, defalcating fiduciaries, and certain fraudulent Indemnitors. The second part of this paper should provide some helpful insights and reminders about Chapter 13 bankruptcies (specifically the principal's eligibility for Chapter 13 relief and the methods to attack reorganization plans which otherwise significantly diminish the fidelity insurer/surety's recovery).

II. CHAPTER 7 CASES/OBJECTIONS BY FIDELITY INSURER OR SURETY TO DISCHARGE.

We all generally understand that when a principal files for bankruptcy, the debtor chooses one of several different "chapters" of the federal Bankruptcy Code. Each chapter allows the debtor a different type of "relief" from the secured and unsecured debts owed. Usually under a Chapter 7 total liquidation unsecured creditors receive nothing--the debtor files a no asset Chapter 7 petition. Even in a Chapter 7 case where the debtor has assets, the administration costs and trustees fees will often consume such a large part of the assets or recovery that the distribution to unsecured creditors is insignificant.

However, the fidelity insurer or surety often find that they can escape the little or no recovery suffered by other creditors of the bankrupt debtor because of the nature of the indemnity obligation. The fidelity or surety representative must ferret out the nature of the debt, the accuracy of the information communicated by the indemnitors to motivate the surety to issue a bond and other dishonest components of the insured/bonded obligation. Thus, the fidelity insurer's or surety's goal in a Chapter 7 case is to show the bankruptcy court that the debtor has committed one of several type of acts relative to the insured, bond obligee or the

surety that prohibits the debtor from escaping the debt claimed.

In other words, if the debt is determined non-dischargeable, the debtor will still owe the fidelity insurer or surety the full debt when the bankruptcy is over if he is in a chapter 7 or chapter 11 bankruptcy, even if his other debts are completely erased. This alone, creates a higher likelihood of recovery for the fidelity insurer/surety in a Chapter 7 proceeding as opposed to a Chapter 13 proceeding.

There are similar acts which prohibit a discharge listed in 11 U.S.C. § 727, which should not be ignored and which relate to the good faith full disclosure and other topics discussed above. However, the focus in this paper is on the specific types of exceptions involving pre-petition obligations upon which the claim of the fidelity insurer/surety is based. These are set forth in 11 U.S.C. § 523(a). This section provides in part:

> "A discharge under section 727. . .does not discharge an individual debtor from any debt--
>
> (2) for money, property, services or an extension, renewal or refinancing of credit to the extent obtained by--
>
> (A) false pretenses, or a false representation or actual fraud. . . .
>
> (3) neither listed nor scheduled under section 521(1). . . .
>
> (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny . . . .
>
> (11) provided for in any final judgment, unreviewable order, consent order or decree entered in any court of the United States or of any State, issued by a Federal depository institutions regulatory agency, or contained in any settlement agreement entered into by the debtor arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union;[1] or
>
> (12) for malicious or reckless failure to fulfill any commitment by the debtor to a Federal depository institution's regulatory agency to maintain the capital of an insured depository institution."

A. <u>Fraud/Embezzlement/Larceny:</u>

When a bonded construction contract principal obtains money from the owner through misrepresentations, and does not use the money for the purpose given by the owner, the obligation created by this deception has been held non-dischargeable. *In Re Dallam,* 850 F.2d 446 (8th Cir. 1988); *In Re Mercado,* 144 B.R. 879 (Bankr. C.D. Cal. 1992); and *In Re Cole,* 164 B.R. 947 (Bankr. N.D. Ohio 1993).

In the *Cole* case the contractor told the owner that he could not purchase supplies on credit and needed a cash advance. Not surprisingly he did not buy the supplies, and it turned out that he could have bought them on credit. The *Cole* court held that the obligation for the

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1 This statute further provides that any institution affiliated party of a depository institution or insured credit union shall be considered to be acting in a fiduciary capacity with respect to the purposes of subsections (a)(4) or (11).

money advanced by the owner was non-dischargeable. A similar result was reached in the *Dallam* case where the contractor provided false lien waivers in exchange for payment.

Several cases have also held that when a bond is obtained by false pretenses (a fraudulent financial statement to secure a bond) the loss suffered by the surety and claimed against the indemnitor is non-dischargeable. *Fidelity & Deposit Company v. Arenz,* 240 U.S. 66, 54 S.Ct. 16, 78 L.Ed 176 (1933); *Matter of Young,* 995 F.2d 547 (5th Cir. 1993); *In Re. Serani,* 937 F.2d 302 (9th Cir. 1992); and *In Re Main,* 133 B.R. 746 (Bankr. N.D. Pa. 1991).

B. <u>Defalcating Fiduciaries</u>:

The Bankruptcy Code provides that a debtor's obligation arising from fraud or defalcation while acting in a fiduciary capacity is non-dischargeable. 11 U.S.C. § 523(a)(4). The earliest reported decisions through the latest decisions applying this statute to cases involving fiduciaries who breach their duties hold that those obligations are non-dischargeable. See *Indemnity Insurance Co. of North America v. Covington*, 14 N.Y.2d 683, 172 Misc. 310 (1939). See also *In Re Martin*, 161 Bankr. 672 (9th Cir. 1993); *In Re Beach*, 13 Bankr. 759 (M.D. Ala. 1981); *In Re Pickering*, 182 Bankr. 268 (D. Mont. 1995), and *In Re Reedy*, 155 Bankr. 169 (S.D. Ohio 1993).

In the *Indemnity Insurance Company* case, an administratrix made improper investments. After the administratrix and her surety were surcharged by the Surrogate Court. The surety attempted to recover from the administratrix. The administratrix filed bankruptcy, and the surety objected to her discharge. The bankruptcy court in New York held that her obligation arose from a defalcation and was non-dischargeable.

An interesting result in the construction context is from the recent case, *In Re Storie,* 216 B.R. 283 (10th Cir. 1997). In *Storie* debtors failed to pay several materialmen and suppliers in connection with the construction of "Hog Barns" in Arkansas. The materialmen and suppliers claimed that the non-payment constituted a defalcation and breach of fiduciary obligations due as contractors under "Oklahoma law," yet there was no allegation of fraud embezzlement or larceny. The *Storie* debtors argued that the loss was caused by a negligent under-estimated construction bid and was not intentional.

The Tenth Circuit Court in *Storie* reversed a lower court decision and held that "defalcation" under section 523(a)(4) does not require some sort of moral dereliction or intentional wrong.

> "We decide. . .that when a fiduciary takes money upon a conditional authority, which may be revoked and knows at the time that it may [be revoked], he is guilty of a 'defalcation' though it may not be a 'fraud,' or an 'embezzlement,' or perhaps not even a 'misappropriation.'"

216 B.R. at 287. "Defalcation includes intentional reckless, and negligent breaches of fiduciary duty, so as to reach the conduct of fiduciaries who are short in their accounts in any way. . . ." 216 B.R. at 288.

The decision in *In Re Martin*, 161 Bankr. 672 (9th Cir. 1993), is also instructive. In *Martin* a surety issued a bond to a conservator (similar to a Georgia guardian). The conservator and the surety were surcharged for a loss to the conservatee and the conservator filed a chapter 7 bankruptcy. The *Martin* court noted that a loss because of mere diminution in value may not be a defalcation, whereas a loss because of a failure to account is wrongful and is a non-dischargeable defalcation.

In *Quaif v. Johnson,* 4 F.3d 950 (11th Cir. 1993) the Court explained that "defalcation" referenced in §523 (4) does not have to rise to the level of fraud, embezzlement or even misappropriation. The Court further observed that the term "defalcation" refers to a failure by a fiduciary to produce funds entrusted to him. *Quaif,* 4 F.3d at 955. In *Quaif* the Court observed that acts of the fiduciary in that case were anything but innocent, and affirmed the decision declaring the fiduciary-debtor's obligation non-dischargeable.

Recently the decision of *In Re Yanke,* 225 B.R. 428 (Minn. 1998) reaffirmed the view that a probate fiduciary who can not account for his ward's funds cannot escape his obligations to the probate court surety in a Chapter 7 bankruptcy proceeding. In *Yanke,* the surety defended the fiduciary/principal before the probate court, and even attempted unsuccessfully to appeal the adverse decision. When the surety paid the bond obligee the obligee executed a satisfaction of judgment in favor of the surety. When the principal/debtor sought bankruptcy protection to escape the surety's salvage efforts, the surety objected to his discharge. The *Yanke* debtor argued that the surety did not have standing to claim that he defalcated in a fiduciary capacity and that the judgment had been "satisfied."

The *Yanke* court made short shrift of these defenses, holding that the surety's direct rights and subrogation status allowed it to object to discharge by virtue of the debtor's defalcation under both state and federal fiduciary concepts. The *Yanke* court also noted the extreme care taken by the surety to have the judgment canceled only as to the surety when the surety paid the bond obligee, and as a result rejected the satisfaction claim of the dishonest fiduciary.

Some other courts have recently made a distinction in the area of exceptions to fiduciary discharge based on whether the loss was caused by "negligence" of a fiduciary or something "more than negligence." Some courts require a wilful neglect of duty as opposed to mere negligence. Others like *Quaif* above observe that the conduct is more than mere negligence. See generally *In Re Baylis*, 222 B.R. 1, 10-11 (Minn. 1998). Most probate jurisdictions do not recognize any distinction between negligent losses and intentional losses. The inquiry is directed towards the fact that funds entrusted to a fiduciary are missing and unaccounted--thus cases like *Storie* reach conclusions based upon merely missing money and not intent or culpability. Culpability is presumed when the money can't be found. The crucial question is whether the principal in these contexts is a fiduciary. If so, the missing funds are usually held to be defalcated.

"There, but for the Grace of God, I go."

Another recent case, which cites and distinguishes the *Quaif* ruling, turned on the question of whether the bonded principal owed a "fiduciary" obligation to the obligee. *In Re*

Johnson, 203 B.R. 1017 (S.D. Ga. 1997). The *Johnson* court denied the surety'' motion for summary judgment based on 11 U.S.C. § 523(a)(4)--defalcation by a person acting in a fiduciary capacity. In *Johnson,* the debtor was a former tax commissioner of a south Georgia County. She was indicted by the grand jury for malpractice, misfeasance, and malfeasance and she plead guilty to each of the three counts in the indictment. The *Johnson* court obviously was not convinced (based on the facts before it on summary judgment review) that Ms Johnson was personally culpable for the missing taxes because it held that Section 523(a)(4) does not apply to frauds of agents, bailees, brokers, factors, partners, and other persons similarly situated. From this observation the *Johnson* court proceeded to analyze the nature of the relationship between the tax commissioner and the county as created by Georgia statutes, and amazingly held that they "do not create a fiduciary relationship between the Tax Commissioner and Bulloch County. . . .The Debtor was therefore not a fiduciary of Bulloch County under a § 523(a)(4) dischargeability analysis." 203 B.R. 1021.

There are some lessons of how not to handle cases from the reported decisions and other cases we handle on a day-to-day basis. The best lesson is that in reaching a compromise with a defalcating principal, the surety/fidelity insurer should reserve all rights and expressly provide that no final settlement exists until the principal has performed every obligation due under the compromise agreement.

In the case *In Re Detrano*, 222 B.R. 685 (E.D. N.Y. 1998) an estate executor sued the trustee of an inter vivos trust in effect during the deceased's lifetime for among other things conversion and fraud. The executor settled the suits with the trustee requiring specific repayments by the trustee and even providing that the obligations were non-dischargeable in bankruptcy. When the debtor breached the settlement agreement and sought bankruptcy discharge, the trustee objected, relying in large part on the agreement that the obligation was non-dischargeable. The debtor, however, relied on the large body of law providing that once a case has been settled, a novation of the first obligation, replaced by the obligations in the settlement agreement, has occurred. The *Detrano* court went to great explanation to demonstrate the invalidity of the nondischargeability stipulation in the settlement agreement. 222 B.R. at 688. Consequently the *Detrano* court observed that even though the original obligations may have been non-dischargeable, the compromise obligations were dischargeable.

When reserving rights to pursue claims for fraud, defalcation and other non-dischargeable debts in favor of some compromise with the principal, the surety/fidelity insurer's representative must remain cognizant of issues like the statute of limitations and fraudulent conveyances. All too often even if these claims are reserved until completion of the compromise, the time period for fulfilling the compromise will cause the right to pursue conversion, fraud, and illegal conveyances to be lost. When a principal or dishonest employee of an insured is "caught" the surety/fidelity representative can not be misled by the appearance of insolvency into losing substantive rights by obtaining a promise to pay over time, amounts which appear beyond the debtor's present ability. The promise to make future payments, which itself is probably dischargeable in bankruptcy, is simply not an acceptable substitute for a present determination that the principal/indemnitor is a liar, or a thief, or a fiduciary who has wasted away his ward's estate.

C. Defalcation by Institution Affiliated Party:

One of the newest areas of interest to fidelity insurers is the addition of the non-dischargeability provisions concerning defalcations by "institution affiliated parties" based on the Crime Control Act of 1990. This amendment makes uniform the results in several prior cases which held that bank directors owe a fiduciary duty to their banks and that the breach of these duties constituted an exception to discharge under § 523(a)(4). *Harper v. Rankin,* 141 F.626 (1907), cert. denied, 200 U.S. 621, 26 S.Ct. 758, 50 L.Ed. 624 (1907); *Hartford Accident & Indemnity Co. v. Flanagan,* 28 F.Supp. 415 (S.D. Ohio 1939); *In Re Sax,* 106 B.R. 534, 539 (N.D. Ill. 1989); and *In Re Wright,* 87 B.R. 1011, 1017-18 (Bankr. D. S.D. 1988).

The definition of an "institution affiliated party" is found in 11 U.S.C. § 101(33) and includes officer employees, directors, or controlling stockholders. See specifically 12 U.S.C. §§ 1813(c)(2) and 1814(a)(2). The congressional intent from these enactments is that officers and directors who are most responsible for the collapse of insured financial institutions should not be allowed to discharge the debts which accrue as a result of their improprieties . *In Re Gaubert,* 149 B.R. 819 (Bankr. E.D. Tex. 1990). The *Gaubert* court held that the stockholder in that cased breached his fiduciary duty of due care and loyalty (duty to avoid acting in personal self interest).

Fidelity insurers of banks, savings and loan associations, and credit unions should take a hard look dishonesty losses to see if they can object to discharge on these grounds. There is a duty of care to depositors, customers, shareholders, regulators, and perhaps to the insurer in many of these situations. Manipulation of records and money in financial institutions is easy. Losses can reach enormous proportions in short periods of time. These debtors must be scrutinized closely.

III. CHAPTER 13 CASES.

Subsequent to the last paper, there have not been any significant changes in the law or the majority and minority divisions on the issues discussed therein. In this paper there are a smattering of new cases mixed into the format of the previous cases to update the principles discussed.

Generally speaking, a debtor who files for relief under Chapter 13 of the Bankruptcy Code will file a plan proposing to repay some or all of his indebtedness equal to at least the amount of the largest unsecured claim or all of his disposable income over a period of 3-5 years.

Most creditors (particularly unsecured creditors) prefer a Chapter 13 proceeding to a Chapter 7 total liquidation, because under Chapter 13 the creditor will receive some form of repayment, even if it is minimal, without having to pay attorneys or other collection agents to do more than file a proof of claim. The prospect of some recovery in a Chapter 13 case as opposed to no recovery in a Chapter 7 case, causes unsecured creditors to favor Chapter 13 proceedings.

A fidelity insurer or surety frequently has an unsecured claim against bankrupt debtors.

This is because the principal will either file for bankruptcy protection before a suit is filed, before a judgment is rendered, or before the judgment is final, which at a minimum makes the claim unsecured in whole or in part. The fact that fidelity insurers and sureties have unsecured claims does not, however, make their interest the same as other unsecured creditors. Fidelity insurers and sureties have different agendas from most unsecured creditors in bankruptcy because of the nature of their claims, and because (as discussed in more detail above) the obligations owed to them may be non-dischargeable under another chapter of the bankruptcy code, particularly when the claims involve dishonest employees, defalcating fiduciaries, or fraudulent indemnitors.

The problem that fidelity insurers and sureties have with Chapter 13 cases is that by payment of less than the full obligation owed to the fidelity insurer, the principal can receive what is often referred to as a "superdischarge." The Chapter 13 debtor with a confirmed reorganization plan can avoid repaying the full debt which otherwise would be non-dischargeable in a Chapter 7 proceeding. Of course, repayment of less than 100% may be acceptable when the fidelity insurer/surety, fully understanding their rights and options, chooses to accept a Chapter 13 proceeding and reorganization plan. Sometimes the principal is so destitute that even a small recovery under Chapter 13 is better than a judgment declaring the entire amount due under Chapter 7 - with no mechanism to generate payment from the principal. The key is, of course, a "full understanding."

Unfortunately, Chapter 13 filings frequently are unchallenged. This is not acceptable if the principal is either not eligible for such a proceeding or where the reorganization plan treats the indemnity obligation in such a disparate manner that it is objectionable. This is particularly true if the principal is employed and otherwise has resources (such as significant equity in his real estate or personal property) to repay his obligation to the fidelity insurer/surety, even if over time.

The following two divisions of Part III address the eligibility issues and the basis for fidelity insurers and sureties to object to a Chapter 13 reorganization plan.

A. <u>Chapter 13 Eligibility</u>:

The definition and eligibility requirements for debtors under Chapter 13 of the United States Bankruptcy Code are set forth in 11 U.S.C. § 109(e). This statute generally provides that only persons who have "regular" income and owe non-contingent, liquidated unsecured debts of less than $250,000.00 and non-contingent, liquidated secured debts of less than $750,000.00 may be debtors under Chapter 13. The "regular" income and $250,000 unsecured debt ceiling requirements are often areas where eligibility issues exist in favor of the fidelity insurer/surety. These are address in the following parts 1 and 2.

1. Regular income

Section 109(e) expressly provides that only debtors who have "regular income" are eligible for relief under Chapter 13. There is no reported case holding that a debtor without a job, or any other regular source of reasonably reliable income is eligible for relief under chapter 13.

Frequently dishonest ex-employees, removed fiduciaries, and other principals who have indemnity obligations, *who are unemployed*, will attempt to escape their obligations to fidelity insurers and sureties through Chapter 13. The reorganization plan must be reviewed to determine the source of the plan payments. Chapter 13 debtors will use gifts from relatives, pension payments, social security payments, savings accounts and other unconventional sources of "income" to fund their plans. Recently the author handled a case where an alleged dishonest employee filed a chapter 13 plan wherein the proceeds from numerous alleged check conversions maintained in the debtor's frozen checking account were proffered as a source to fund the reorganization plan *(and not surprisingly pay all creditors* ***other than*** *the employer from whom the checks were allegedly stolen).*

In the cases where a debtor funds a plan through some source other than wages, the test employed by the courts to determine whether the debtor has regular income is measured by the stability and reliability of the source offered to fund the plan.

In *In Re Hanlin,* 211 B.R. 147 (W.D.N.Y. 1997) the Court held that an unemployed student whose only revenues were approximately $650.00 from "friends and family" did not qualify as an individual with regular income eligible for relief under Chapter 13. Across the state, the Court in *In Re Antoine*, 208 B.R. 17 (E.D.N.Y) held that an unemployed debtor whose wife had a "stable regular income" was qualified and his plan was confirmed.

The court in *In Re Ross*, 173 B.R. 943 (Bankr. E.D. Okla 1994) held that certain debtors did not have reliable income where they were partners with a relative and the relative handled all receipts and disbursements, allocated expenses between himself and the debtors and solely determined the amount of income the debtors would receive.

In the case of *In Re Cregut,* 69 B.R. 21 (Bankr. D. Ariz. 1986), the court ruled that gifts to the debtor by his father did not satisfy the regular income requirement. The court observed that the debtor was not employed and that nothing in the record assured that the proffered "income" was stable or otherwise reliable.

A similar result was reached in the recent case of *In Re Sigfrid,* 161 B.R. 220 (Bankr. D. Minn. 220 (1993). In *Sigfrid,* the debtor's husband even filed an affidavit specifying that he would provide the debtor with sufficient funds to pay for her Chapter 13 plan. Despite this affidavit, the *Sigfrid* court concluded that the debtor was ineligible for relief under Chapter 13. The *Sigfrid* Court reasoned that without the thorough liability and asset disclosures required of the debtor, promises by the spouse were not reliable.

The debtor in *In Re Crowder,* 179 B.R. 571 (Bankr. E.D. Ark. 1995) was still in jail when he filed for Chapter 13 relief. The court ruled that the debtor's search for post incarceration employment (two years into the future) was insufficient to establish regular and stable income.

Some courts have held that welfare, pension and social security benefits are sufficient to qualify as regular income. *In Re Hagel,* 184 B.R. 793 (9th Cir. 1995). However the purpose of such receipts must be analyzed. Social security disability child support benefits are not regular income when they may terminate and are for the benefit of someone other than the debtor. *In Re Crowder,* 179 B.R. 571 (Bankr. E.D. Ark. 1995).

2. Liquidated/Non-Contingent Debt Less than $250,000.00.

A Chapter 13 debtor must have non-contingent, liquidated debts less than $250,000.00. 12 U.S.C. § 109(e). A threshold issue is whether the fidelity insurer's claim is liquidated/non-contingent. The second inquiry is whether it exceeds the debt ceiling of § 109(e).

a. Misappropriation Claims are Liquidated.

The question of whether a claimed debt is non-contingent or liquidated is a question of law. *United States v. Verdunn,* 89 F.3d 799 (11th Cir. 1996); *In Re Nicholes,* 184 B.R. 82 (9th Cir. 1995). The majority of reported decisions from bankruptcy courts considering claims for misappropriation against chapter 13 debtors hold that such claims are liquidated. *Matter of McGovern,* 122 B.R. 712 (Bankr. N.D. Ind. 1989); *In Re Furrey,* 31 B.R. 495 (E.D. Pa 1983); *In Re Jordon,* 166 B.R. 201 (Bankr. D. Me. 1994); and *In Re Jerome,* 112 B.R. 563 (Bankr. S.D. N.Y. 1990).[2] The most restrictive ruling of claims for misappropriation was set forth in *In Re Lambert,* 43 B.R. 913 (Bankr. D. Utah 1984), which held that, when disputed, the claim for misappropriation is unliquidated. Following is a discussion of some of the principles and rationales of some of the cases which hold that claims for misappropriation are liquidated under the Bankruptcy Code.

In *Jordan*, the debtor's employer accused him of misappropriating $280,000.00. When the employer filed suit, the debtor filed for relief under Chapter 13. The debtor disputed the employer's claim, but the *Jordan* trustee filed a motion to dismiss the case because of the debt ceiling in § 109(e). The *Jordan* court observed that the existence of a dispute by the debtor does not render the debt contingent or unliquidated, and dismissed the case. *Jordan,* 166 B.R. at 202.
See also *In Re Wenberg,* 94 B.R. 631 (9th Cir. 1988). A claim is liquidated if the amount due can be determined by simple mathematics.

Challenges to eligibility because of the amount of the claim against dishonest employees, defalcating fiduciaries, and fraudulent indemnitors can establish an extremely advantageous spin on the proceedings against such debtors. Proceedings involving eligibility do *not* determine the validity of the claim. The inquiry merely determines whether the amount of the claim exceeds the debt ceiling--usually a simple exercise in addition-but with the benefit of showing the Judge the examples of dishonesty or defalcation without a foundation/explanation. These examples most often will include copies of converted checks, fictitious account credits, bond claim payments, etc. This is an excellent opportunity to show the fruits of theft without allowing the debtor to challenge the claim.

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2 Under Georgia law, the claim for misappropriation, whether characterized as "conversion" or for "theft" is liquidated. *Gardin v. Halpern*, 184 Ga. App. 10, 360 S.E. 2d 729, 732 (1987); *International Indemnity Co. v. Terrell,* 178 Ga. App. 570, 344 S.E. 2d 239 (1986). *National Bank of Georgia v. Refrigerated Transport Co.,* 147 Ga. App. 240, 248 S.E. 2d 496 (1978), (claim for conversion of checks is liquidated); *Allen v. Allen*, 198 Ga. 269, 280, 31 S.E. 2d 481 (1944), (prejudgment interest is due on money obtained through fraud, theft, or artifice from date of taking); O.C.G.A. § 7-4-15 (prejudgment interest is available only for liquidated debts). See also *Wheels and Brakes, Inc. v. Central Ford Truck Sales, Inc.*, 167 Ga. App. 532, 307 S.E. 2d 13, 15 (1983) (interest unavailable on liquidated claim for theft from date of taking).

In the case, *In Re McGovern,* 122 B.R. 712 (Bankr. N.D. Ind. 1989), the Indiana State Board of Accounts conducted an audit which suggested that the debtor was responsible for misappropriated money. One of the debtor's creditors moved to have the Chapter 13 case dismissed because the amount of claims for misappropriation exceeded the liquidated debt ceiling in 11 U.S.C. §109(e). The bankruptcy court granted the motion and the *McGovern* decision denied the debtor's subsequent motion to alter/amend the dismissal.

The *McGovern* court held that the court does not determine the validity of a claim when evaluating Chapter 13 eligibility because this is a preliminary inquiry. The issue is whether the claim is based on "data which, if believed makes it possible to compute the amount with exactness." *McGovern,* 122 B.R. at 715, citing *Matter of Vaughn,* 36 B.R. 935 938 (Bankr. N.D. Ala. 1984), *aff'd* 741 F.2d 1383 (11th Cir. 1984). The *McGovern* court further observed that while there might be some question or issue about whether the debtor actually misappropriated the amounts claimed, the determination as to amount requires no exercise of judgment or discretion. "Instead it will be a simple matter of computation, by adding up the various sums of money. . . . Such a process results in a liquidated rather than an unliquidated claim." The ability of the debtor to challenge his liability for a clearly determined amount claimed in excess of the Chapter 13 debt ceiling "must be exercised in a different forum under the auspices of a different chapter of the Bankruptcy Code." *McGovern,* 122 B.R. at 715.

The *Vaughn* decision, cited in *McGovern,* held that a disputed debt is not necessarily unliquidated. Like *McGovern*, the court in *Vaughn* ruled that the fact of a dispute as to liability is really irrelevant to the issue of Chapter 13 eligibility. The *Vaughn* debtor admitted the amounts of the debts claimed but merely argued that they were unliquidated because he disputed his liability for them.

The *Vaughn* court cited authorities which hold that such disputes are not relevant for purposes of § 109(e) eligibility. Even the existence of affirmative defenses or counterclaims which might reduce the amount of the claims is not relevant. *Vaughn,* 36 B.R. at 940 citing *In Re Sylvester,* 19 B.R. 671 (9th Cir. 1982). The only question, according to *Vaughn,* is whether the claim is based on data which, if believed makes it possible to compute the amount exactly. "Examples are . . . claims for money had and received." *Vaughn,* 36 B.R. at 938.

Just as important as the direction in *Vaughn* that claims for money had and received are liquidated debts, is the court's discussion of the adverse impact of allowing Chapter 13 cases to proceed in the face of disputed claims for definite amounts in excess of the Chapter 13 debt ceiling. The *Vaughn* court observed that allowing Chapter 13 cases to continue while disputes are resolved about claims for definite amounts would cause a flood of "disputes" that would utterly thwart the process in Chapter 13 bankruptcy proceedings.

> "It is easy to envision debtors regularly using such a 'dispute' technique as a stalling device. If such a device were given judicial recognition it would create havoc. The unscrupulous would file a Chapter 13 petition and then 'dispute' the unsecured debts, force the litigation to continue under Chapter 13, and then after months of costly delay, the bankruptcy court would find that all had been in vain because the 'disputes' were only imagined, and that the bankruptcy court lacked jurisdiction to adjudicate the claims."

Vaughn, 36 B.R. at 939.

In *United States v. Verdunn,* 89 F.3d 799 (11th Cir. 1996), the debtor vigorously disputed the tax deficiency claimed by the IRS in its proof of claim for current underpaid taxes based on statutory fraud penalties as applied to prior tax returns. The debtor claimed that the debt was unliquidated because: (1) the deficiency notice was insufficient; (2) he disputed the debt; and (3) evidentiary hearings were necessary to determine his liability. The Court in *Verdunn* disagreed.

The Court observed that the IRS would have the burden of proving fraud to make the debtor liable for its claim, but held that the issue for determining eligibility for Chapter 13 was not based on certainty of liability, but the definiteness of the amount of liability claimed, *i.e.,* its liquidity. 89 F.2d at 802, citing *In Re McGovern,* 122 B.R. 712, 715 (Bankr. N.D. Ind. 1989).

Based on the premise that the central question of liquidated debt depended on the certainty of the amount of debt, the *Verdunn* Court turned to an analysis of whether the IRS' claim was susceptible of quantification without opinion or discretion as to the amount. Noting that the notice of deficiency set forth the statutory methods for calculating tax liability for fraud, the Court ruled that through the application of ***fixed legal standards*** the amount of the debtor's debt was easily ascertainable. 89 F.3d at 803. Therefore the claim for fraud, even though unproven, was added to the liquidated debts and caused them to exceed the debt ceiling. The *Verdunn* Court reversed the orders denying the motion to dismiss the case and remanded the case to the bankruptcy court with instructions for dismissal. 89 F.3d at 803. Even though the plan had previously been confirmed, the case was dismissed because the *Verdunn* debtor was ineligible for Chapter 13 relief.

b. Once a claim is determined to be one that is liquidated, the eligibility <u>issue turns on the amount</u>.

While determination of whether the type of claim is liquidated/non-contingent may be a question of law, the question of whether the amount exceeds the debt ceiling has been held to be a question of fact. *In Re Nicholes,* 184 B.R. 82 (9th Cir. 1995); *In Re Johnson,* Lexis 1938 (Bankr. D. Ariz. Oct. 5, 1995). See also *Matter of Vaughn,* 36 B.R. 935 938 (Bankr. N.D. Ala. 1984), *aff'd* 741 F.2d 1383 (11th Cir. 1984). The test announced in *Vaughn* (whether the claim, if believed, is based on data which makes it possible to compute the amount with exactness) and the procedural fact that the review is only a preliminary inquiry, makes the issues in connection with this motion analogous to those on a motion to dismiss. The allegations are taken as true, and, as presumed true, can someone simply total the claims to an exact number for the court at the hearing?

It goes without saying that the organization of the supporting instruments/documents in groups should be undertaken to make the mathematical exercise easy. Perhaps more importantly early organization of these documents will not only make the mathematical exercise easy (and thus less expensive for the fidelity insurer in the speeding inquiry involved in the bankruptcy setting) but they should be organized in such a fashion as to suggest on their face the debtor's improper activity. This will plant an important seed in the judge's mind that

the debtor is trying to escape an otherwise non-dischargeable debt.[3]

There are other exhibits which demonstrate the amount of the debt, such as the proof of claim. A proof of claim filed in accordance with the rules of the Bankruptcy Court is *prima facie* evidence of the validity and the amount of the claim. Fed R. Bankr. P. 3001(f). The proof of claim filed by Creditor was *prima facie* proof that Debtor's debts exceed the Chapter 13 debt ceiling. *In Re Jerome,* 112 B.R. 563 (S.D. N.Y. 1990). Care should be taken to submit summaries of the components of the loss paid with the proof of claim. This need for summaries of voluminous documents is another reason why organization at the adjusting process is critical to holding down expenses when and if the matter is placed in bankruptcy.

The fidelity insurer/surety can also utilize the copies of its checks to prove the certainty of the amount of its debt claim.

B. Objections To A Chapter 13 Reorganization Plan.

Even if the claim against the kinds of principals that are the subject of this discussion is less than the Chapter 13 debt ceiling, a fidelity insurer/surety may still avoid the undesirable consequences of a Chapter 13 plan discussed herein. The nature of the fidelity insurer/surety's claim (*i.e.,* an otherwise non-dischargeable debt) frequently is the basis to object to the principal's reorganization plan. There are other arguments for rejection of a plan, some of which relate to the fact that the debt would otherwise be non-dischargeable.

The six requirements for confirmation of a Chapter 13 reorganization plan are set forth in 11 U.S.C. § 1325(a). They are summarized as follows:

(1) the plan complies with Chapter 11 and the applicable provisions of Title 11 of the United States Code;
(2) all fees and charges of Chapter 123 of Title 28 are paid;
(3) the plan is proposed in good faith and not by any means forbidden by law;
(4) the value of property distributed through the plan to allowed unsecured claims is not less than would be paid if the estate is liquidated under Chapter 7;
(5) payment proposed for secured claims is accepted by the secured creditors, or liens and value security are recognized, or the secured property is surrendered by debtor;
(6) the debtor can make all the payments required under the plan.

The 3rd, 4th, and 6th elements are most frequently the basis for successful objections by fidelity insurers and sureties. The following four subdivisions of this paper will discuss the

3 Recently the author presented more than 280 separate instruments which an employee/debtor was accused of converting from her employer to a bankruptcy court in a eligibility contest. The instruments were grouped into 5 categories (checks written by the employee for payment of personal credit card debt, checks written by the employee to the employee's spouse, checks written by the employee to the employee, checks written to the employee's family, and checks written by the employee for cash). The evidence proving the theft of the cash checks was conspicuously less probative than for the other conversions. Nevertheless because of the impact of the organization of these instruments, (which when added together easily exceeded the Chapter 13 debt ceiling) the debtor's dishonesty was obvious from the instruments themselves. The debtor made a quick retreat and dismissed the Chapter 13 proceeding, even before the fidelity insurer had to defend the debtor's objection to its claim or submit evidence to attack the reorganization plan.

burden of proof in connection with objections to plans, the good faith requirement, equal or better receipts under Chapter 7, and plan feasibility.

1. The Debtor Has the Burden of Proving All The Required Elements of A Reorganization Plan.

Chapter 13 debtors have the burden of showing that the reorganization plan meets the confirmation requirements of § 1325(a). *In Re Humphrey,* 165 B.R. 508 (M.D. Fla. 1994). From the fidelity insurer and surety's perspective it is important to note that this burden is higher in a case where the debtor seeks to discharge debts that would otherwise be non-dischargeable under Chapter 7. *In Re Elisade,* 172 B.R. 996 (Bankr. M.D. Fla. 1994); and *In Re Norman,* 162 B.R. 581 (Bankr. M.D. Fla. 1993).

2. The Good Faith Requirement.

The requirement under U.S.C. § 1325(a)(3) that a plan be proposed in good faith means that a debtor must do more than merely comply with statutory requirements. "Good faith" envisions a broad judicial inquiry into the debtor's state of mind. *In Re Norman,* 162 B.R. 581 (Bankr. M.D. Fla. 1993); *In Re Wall,* 52 B.R. 613, 616 (Bankr. M. D. Fla. 1985). When evaluating a debtor's good faith courts will consider the debtor's respect for the underlying goals and policies of Chapter 13 and use of the process to further the policy of securing orderly and fair adjustment of debtor creditor relationships. *In Re Northwest Place, Ltd.,* 108 B.R. 809 (Bankr. N.D. Ga. 1988). Central to the "fair" adjustment between debtor and creditors is "candor." *In Re Waldron,* 785 F.2d 936, 941 (11th Cir. 1986).

Similar factors considered by the courts to determine if a plan has been proposed in good faith include, but are not limited to, the following:

--The circumstances under which a debtor debt arises and the candor or lack of same in dealing with creditors;
--the type of debt and whether it would be non-dischargeable under Chapter 7;
--accuracy (or lack thereof) of the plan's statements of debt and whether the plan attempts to mislead the Court; and
--the hardship of the plan on the debtor/amount offered to creditors.

In Re Kitchens, 702 F.2d 885, 888 (11th Cir. 1983).

a. Lack of candor and a lack of respect for <u>Chapter 13 goals and policies</u>.

The Court in *In Re Brooks,* 216 B.R. 838 (N.D. OK. 1998) recently dismissed a chapter 13 case for lack of respect for Chapter 13 policies and goals. The principal debt in *Brooks* was an otherwise non-dischargeable tax obligation and had previously been the subject of another failed chapter 13 filing.

The Federal District Court in *In Re Goddard,* 212 B.R. 233 (N.J. 1997) recently reversed

a bankruptcy court decision which had denied a motion to dismiss a chapter 13 bankruptcy petition due to inaccurate reports of debts and expenses.

The facts and holding in *Norman,* referenced above, are insightful as to an absence of candor in proposing a plan. In *Norman* the debtor filed a plan which proposed full payment of priority tax claims but only 21 per cent of unsecured claims. Prior to filing his petition the *Norman* debtor had filed delinquent tax returns for two of the three years immediately preceding his bankruptcy petition without paying the tax due. These taxes were entitled to a priority. The *Norman* debtor did not file returns for the 3 years prior to those years for which he filed. The tax claims of more than $86,000 for the unfiled years were not entitled to priority--they were general unsecured claims. These unsecured tax claims were the only significant unsecured claim against the *Norman* debtor.

The *Norman* court observed that while the record did not show fraud by the debtor, the nature of the relief sought in Chapter 13 was discharge of an otherwise non-dischargeable debt--tax liability. This "superdischarge" while offering a "pittance to his only meaningful creditor" demonstrates an effort to manipulate the Bankruptcy Code. Thus, the *Norman* court held the debtor failed to prove good faith and sustained the objection to his plan.

b. Non-dischargeable debts = most significant <u>obligation = no good faith</u>.

The recent decision in *Brooks,* discussed above, is illustrative of the rule that (when the principal debt involved in a Chapter 13 case would not be dischargeable under another chapter) the case will be dismissed because of the absence of good faith.

The court in *Kitchens*, observed that the type of debt and whether it would be non-dischargeable under Chapter 7 is another of several factors that demonstrate when a reorganization plan is not offered in good faith. This factor (which standing alone does not indicate an absence of good faith) swells in importance when the *bulk* of debt to be avoided would be non-dischargeable under Chapter 7. *Norman*, 162. B.R. 581. As referenced above, the debtor's burden to establish that a plan is proposed in good faith is greater when the debtor seeks to discharge debts that would not be dischargeable under Chapter 7.

> "A debtor should not be allowed to obtain money, services or products by larceny, fraud or other forms of dishonesty and then to keep his gain by filing a Chapter 13 petition within a few days. . . .Where the debtor's primary and overriding purpose is to manipulate Chapter 13 as a device to escape nearly all of his liability, i.e., [where] the large majority of non-dischargeable debts are tainted with fraudulent conduct, the Chapter 13 plan should not be confirmed."

Norman, 162 B.R. 581.

One recent case rejected confirmation of a chapter 13 plan analyzing the good faith by a comparison of the totality of the treatment of an otherwise non-dischargeable debt to the treatment of dischargeable debts. *In Re McLaughlin*, 217 B.R. 772 (W.D. Tex. 1998). The

creditor in McLaughlin obtained a judgement against the debtors for breach of fiduciary obligation in connection with their operation of a Medicare financed home health care business. "In light of our general adherence to a 'totality of circumstances' standard a lack of substantial repayment by itself is not determinative of good faith, but when combined with other circumstances may be one of many factors considered." 217 B.R. at 777. The court looked at the debtors pre-petition conduct, the timing of the bankruptcy in relation to the judgment based on that judgment and the unfavorable treatment afforded the creditor based on the pre-petition conduct. 217 B.R. at 777.

3. Equal Or Better Treatment Of Claim Than Under Chapter 7.

While it is often tempting to tell one of the kinds of principals upon which this paper is based that the fidelity insurer/surety will object to any Chapter 13 plan because the debt is non/dischargeable under Chapter 7,[4] that fact usually does not satisfy the requirement of 11 U.S.C. § 1325(a)(4) which requires that each creditor receive property under the plan which is equal to or better than would be distributed through a Chapter 7 liquidation. *In Re Walsey,* 7 B.R. 779 (Bankr. N.D. Ga. 1980); *In Re. Vratanina,* 22 B.R. 453 (Bankr. N.D. Ill. 1983); *In Re Yee,* 7 B.R. 747 (Bankr. S.D. N.Y. 1980); *In Re Thorson,* 6 B.R. 678 (Bankr. D. S.D. 1980). In other words, the fact that a debt is non-dischargeable does not mean that the property is distributed.

It is probably obvious that the sufficiency of a plan as compared to a Chapter 7 total liquidation is made on a case by case analysis. However, experience indicates that dishonest employees, defalcating fiduciaries, and fraudulent indemnitors will often fail to include the claim of the fidelity insurer/surety. Sometimes the claim will be identified but will be given no value. Sometimes the value stated is less than the amount claimed by the fidelity insurer/surety. Other times the full claim will be listed, but disputed. All of these tactics have the effect of ignoring the fidelity insurer/surety's claim in the plan and thus the fidelity insurer/surety are given an open door to challenge the plan and argue that it provides for disparate/unequal treatment.[5]

The Court in *McLaughlin*, discussed above under the good faith section, also addressed the relationship of the plan in that Chapter 13 case to the recovery the creditor might make in a Chapter 7 case--the best interest test of § 1325(a)(4). This test requires the Court to analyze the present value of the debtor's assets to the value they may have in the future. In *McLaughlin* the court considered the present value of a least 1 known promissory note and stock in an ongoing business, which together with other assets was given as security to certain creditors who were being paid nearly 100%. The court noted the value of the corporate license and client list and its profit history and therefore ruled that impaired the creditor would receive more in Chapter 7 case.

Another good example of a case where a Chapter 13 plan provided for less to

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4 See *In Re Steinhorn,* 27 B.R. 43 (Bankr. S.D. Fla. 1983).

5 This objection is more properly an objection to the good faith requirement of the plan. While debtors may classify their creditors into categories and treat each category differently, the differing treatment must be fair and equitable under the circumstances. *In Re Mielke,* 39 B.R. 556 (Bankr. D. N.D. 1984).

unsecured creditors than through a Chapter 7 liquidation was *In Re Hardy*, 755 F.2d 75 (6th Cir. 1985). In *Hardy* the plan called for payment of 100% of unsecured claims in full over a five year period. However, the debtor's real estate apparently had sufficient equity beyond the statutory exemption to pay all creditors in full through immediate liquidation. The *Hardy* court held that confirmation was properly denied under these facts.

Many cases have held that even where the distribution to the unsecured creditor pursuant to a Chapter 13 plan is $0.00, the plan may still be confirmed, if the unsecured creditor would receive nothing in a Chapter 7 total liquidation. *In Re Cloutier,* 3 B.R. 584 (Bankr. D. Col. 1980); *Matter of Esser,* 22 B.R. 814 (Bankr. E.D. Mich. 1982); *In Re Walker,* 153 B.R. 565 (Bankr. D. Ore. 1993); and *Matter of Cole,* 3 B.R. 346 (Bankr. S.D. W.Va. 1980).

A related issue is raised by subpart (b) of Section 1325. This subdivision provides that a Chapter 13 plan may not be approved if the value of the property distributed under a plan is less than the amount of the allowed claim of any unsecured creditor or is less than all the debtor's projected disposable income on the date the plan begins. This means that the fidelity insurer/surety needs to prepare and submit its proof of claim as soon as possible in order to insure that the plan pays an amount at least as much as its claim if the disposable income is not an issue.

There are numerous decisions which have addressed the issues of disposable income available to a debtor to fund a plan. The adjuster and attorney should pay close attention to the kinds of expenses a debtor declares in order to arrive at the disposable income offered monthly to fund the plan. Frequently, debtors in reorganizing their financial affairs will attempt to set aside significant sums of money for recreation, transportation, or maintain a standard of living to the prejudice of their creditors. See *In Re Curry,* 77 B.R. 969 (Bankr. S.D. Fla. 1987); *Matter of Hale,* 65 B.R. 893 (Bankr. S.D. Ga. 1986); *In re Stein,* 91 B.R. 796 (Bankr. S.D. Ohio 1988); and *In Re Adamu,* 82 B.R. 128 (Bankr. D. Ore. 1988).

4. Plan Feasibility.

Like the equal or better treatment under Chapter 13 requirement, this analysis also frequently turns on the facts involved in the case and the plan submitted by the debtor. The reality borne out in cases where dishonest employees, defalcating fiduciaries, and fraudulent indemnitors seek bankruptcy protection in a Chapter 13 proceeding is that the plan seldom takes into consideration the amount of the claim by the fidelity insurer/surety. The insurer and surety must act quickly to object to the plan and gather the evidence to demonstrate that the plan as submitted will not work--i.e. by including the omitted claim in the debts to be paid to demonstrate that the debtor can not pay the percentage of debts proposed in the plan through the payments proposed.

IV. CONCLUSION

While the original paper and this update are by no means a complete discussion of the strategies and issues involved when a dishonest employee, defalcating principal or fraudulent indemnitor attempts to hide in bankruptcy, it should serve as a reminder and ready source for

some of the principles which are designed to inhibit these kinds of principals from using the Bankruptcy Courts as a safe haven. These improper acts carry a heavy burden for not only their immediate creditors but for society as a whole. Great diligence should be employed to make them exonerate the fidelity insurer and surety as fully as possible.

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In addition to representing sureties in connection with performance and payment bond claims and emloyee dishonesty claims, a significant amount of Mr. Burson's legal work involves defending sureties from claims against bonds issued for fiduciaries. Mr. Burson represented the surety in *Continental Insurance Company v. Gazaway,* 216 Ga. App. 125, 453 S.E.2d 91 (1994) where he obtained reversal of a trial court ruling holding a surety liable under the principle of apparent authority when a probate court took a bond from an agent whose powers had been revoked by the surety without notice from the surety to the probate court.

Mr. Burson is also a co-author of a number of articles, including "Crime Policies and Other Insuring Agreements (or Policy Interpretations Become Curiouser and Curiorser)," ABA National Institute on Fidelity Bonds, November 1991. He is a member of the American Bar Association, and the Association of Trial Lawyers of America.