EIGHTEENTH ANNUAL SOUTHERN SURETY AND FIDELITY CLAIMS CONFERENCE

New Orleans, Louisiana
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OBJECTING TO THE DISCHARGE OF THE DEBTOR IN FIDELITY AND MISCELLANEOUS BOND CASES

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INTRODUCTION

Integrity Surety Company issues separate bonds on behalf of Principal, who is Guardian over her two children, both of whom received several hundred thousand dollars in insurance proceeds upon their father's death. Principal never files an accounting, inventory or settlement in the fifteen (15) years she acts as Guardian. Upon reaching majority, the children demand their money from their mother/principal, who is unable to account for it. As it turns out, the principal has blown most of the former minors' funds at various casinos and gambling establishments in Biloxi, Mississippi.

The former minors petition the Probate Court to require the Principal and Integrity to file final settlements of the Estates. Settlements are filed, a trial is held and separate judgments are entered against the Principal and Integrity in both Estates. The Judgment Orders do not expressly state that the Principal embezzled funds, committed fraud or otherwise breached her fiduciary duties as Guardian. Integrity satisfies the judgments and moves for matching judgments against its Principal, plus attorney's fees and costs. Judgments are entered, but the Principal then files for protection under Chapter 7 of the Bankruptcy Code.

Is there any hope of recovery by Integrity? What are the surety's options, if any, in Bankruptcy Court? If there is any basis to object to the Principal's discharge in bankruptcy, is it worth the expense, especially when salvage prospects are not otherwise promising or are downright bleak?

NON-DISCHARGEABLE DEBTS UNDER THE BANKRUPTCY CODE

One of the primary purposes of the United States Bankruptcy Code is to provide individual debtors with a "fresh start" – an opportunity to discharge debts and begin anew. Generally, objections to a debtor's discharge will be construed against the objector and liberally in favor of the debtor. *See, e.g.*, *In re Scarlata,* 979 F.2d 521 (7th Cir.1992); *In re Hunter,* 780 F.2d 1577 (11th Cir. Fla. 1986); *Rosen v. Bezner*, 996 F.2d 1527 (3d Cir. 1993). That said, however, discharge is a privilege granted to the honest debtor and not a right accorded to all who seek the protection afforded by the United States Bankruptcy Code. *See Grogan v. Garner*, 498 U.S. 279, (1991)(noting that discharge is only for the "honest but unfortunate debtor."); *see also In re Burgess*, 955 F.2d 134 (1st Cir. Mass. 1992); *In re Horridge*, 127 B.R. 798 (S.D. Tex. 1991) (discharge not a matter of right); *In re Pimpinella*, 133 B.R. 694 (Bankr. E.D.N.Y. 1991). Moreover, some obligations or debts of the debtor may themselves be exempt from discharge.

11 U.S.C. §523 specifically excepts various categories of debts from the discharge granted by the Bankruptcy Code. From the perspective of the fidelity insurer or commercial surety, the most significant exception is set forth in 11 U.S.C. §523(a)(4), which provides, in part:

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

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

In order for a debt to fall within the scope of 11 U.S.C. §523(a)(4), the debtor must have been acting as a fiduciary and the actions giving rise to the indebtedness must constitute a defalcation or a fraud. The term "fiduciary," as it appears in 11 U.S.C. §523(a)(4), is not to be construed expansively, but is limited to "the class of fiduciaries including trustees of specific written declarations of trust, guardians, administrators, executors, or public officers...". *In re Swanson*, 231 B.R. 145, 148 (Bankr.D.N.H. 1999); *see also In re Reeves*, 124 B.R. 5, 9 (Bankr.D.N.H.1990); *Quaif v. Johnson*, 4 F.3d 950, 953 (11th Cir. 1993). For purposes of 11 U.S.C. §523(a)(4), the term has also been specifically applied in the context of a guardianship or conservatorship over the Estate of a minor. *See Scott v. Scott*, 1999 WL 33581945 (Bankr.S.D.Ga. 1999); *In re Swanson*, 231 B.R. at 148.

Fraud under § 523(a)(4) is the same fraud as that required under § 523(a)(2)(A) of the Bankruptcy Code. *McDaniel v. Border*, 181 B.R. 883 (Bankr. S.D.Tx. 1994). The debtor must: (1) misappropriate funds (2) know that she was misappropriating funds (3) do so intentionally, and (4) cause a loss to the other party. *Id.* Defalcation, as that term is used in § 523(a)(4), has been defined by the Eleventh Circuit as "a failure to produce funds entrusted to a fiduciary." *Quaif*, 4 F.3d at 955. Such a failure can be intentional, reckless, negligent or innocent. In *Quaif*, the debtor's actions resulting in the nondischargeable defalcation were intentional, being "far more than innocent mistake or even negligence." *Quaif*, 4 F.3d 955. Therefore, in the Eleventh Circuit an intentional action is a defalcation that is not dischargeable.

The Court of Appeals in *Quaif* acknowledged, however, that the law is not clear as to what other types of actions are nondischargeable defalcations. All cases would hold an intentional or fraudulent act is a defalcation. The greyer area is whether reckless, negligent or even innocent actions of a person can be defalcations. *See SunTrust Bank v. Roberson*, 231 B.R. 136, fn. 3 (Bankr. S.D.Ga. 1999); *Houston v. Capps*, 193 B.R. 955,966, fn. 6 (Bankr.N.D. Ala. 1995). As noted by the Court of Appeals in *Quaif*:

> the precise meaning of "defalcation" for purposes of § 523(a)(4) has never been entirely clear. . . An early, and perhaps the best, analysis of this question is that of Judge Learned Hand in *Central Hanover Bank & Trust Co. v. Herbst,* 93 F.2d 510 (2d Cir. 1937). Judge Hand concluded that while a purely innocent mistake by the fiduciary may be dischargeable, a "defalcation" for purposes of this statute does not have to rise to the level of "fraud," "embezzlement," or even "misappropriation." *Id*. at 512. Some cases have read the term even more broadly, stating that even a purely innocent party can be deemed to have committed a defalcation for purposes of § 523(a)(4).

Quaif, 4 F.3d at 955 (cites omitted).

The First, Fifth, and Seventh Circuits hold that reckless defalcations are nondischargeable misappropriations, but negligent and innocent defalcations are dischargeable in bankruptcy. *Rutanen v. Baylis*, 313 F. 3d 9 (1st Cir. 2002); *Schwager v. Fallas*, 121 F.3d 177, 184 (5th Cir. 1997)(holding the same); *Meyer v. Rigdon*, 36 F.3d 1375 (7th Cir. 1994)(same). Other cases hold that negligent and even innocent defalcations are nondischargeable pursuant to § 523(a)(4). *Antlers Roof-Truss & Builders Supply v. Storie*, 216 283 (10th Cir. 1997); *Resources, Inc. v. Merrill*, 246 B.R. 906 (Bankr. N.D.Okla. 2000). The cases that hold that negligent and mistaken or innocent defalcations are not dischargeable look at the language of § 523(a)(4), which does not differentiate among levels of defalcation. It states that defalcations while acting in a fiduciary capacity are nondischargeable. These courts conclude that a fiduciary acting in a way that harms a beneficiary is a serious issue, regardless of the fiduciary's intent.

The First, Fifth and Seventh Circuits hold otherwise. In the case of *Rutanen v. Baylis*, 313 F.3d 9, 20 (1st Cir. 2002) the Court of Appeals held that "to show defalcation, a creditor need not prove that a debtor acted knowingly or willfully, in the sense of specific intent. However, a creditor must be able to show that a debtor's actions were so egregious that they come close to the level that would be required to prove fraud, embezzlement, or larceny." The Court made a thorough analysis of the policy and statutory reasons for this view. All other sections of 523 that deal with nondischargeable debts deal with serious actions or inactions by debtors or fraud, embezzlement, larceny, willful and malicious injuries, drunken operation of vehicles, etc; or (2) with situations where repayment is important for policy reasons--taxes, family support obligations, student loans, restitution, etc. None envision innocent or even wholly negligent behavior. Sweeping innocent or negligent behavior into § 523 would also directly negate the "fresh start" policy of the Bankruptcy Code. *Baylis* at 313 F.3d 19.

In *Baylis*, the First Circuit distinguished between negligent/innocent and reckless actions of fiduciaries. There a trustee of a testamentary trust was alleged to have violated (1) his duty of loyalty to the beneficiaries by using trust funds for his own benefit and (2) his duty of reasonable care by his failure to sell trust property when appropriate. The First Circuit held that a violation of the duty of loyalty was presumptively a defalcation. *Baylis*, 313 F.3d 20-21. This is due to the "very high and very strict standard for [a fiduciary's] conduct whenever his personal interest comes or may come into conflict with his duty to his beneficiaries." *Id*. (citing 2A A.Scott, *The Law of Trusts* § 170.25). When a trustee puts his or her own self-interest above a trust's beneficiaries, the standard of behavior to which he or she is held is "more rigorous." *Baylis*, 313 F.3d 21 (citing 2A A.Scott, *The Law of Trusts* § 170.25).

The Court of Appeals further held that a duty of care violation was only a defalcation if the trustee acts recklessly. There is no presumption of defalcation. The duty of care for a trustee can be violated if the trustee does not act reasonably. *Baylis*, 313 F.3d 22. Such an action is not always reckless. For instance, a trustee might make poor investments that are only clearly poor in hindsight or a trustee might sell an asset for a lesser amount than might be realized with more diligence. Mistakes that only appear unwise in hindsight or due to poor investment advice from qualified consultants would not be actionable. However, if a trustee chooses very risky investments or fails to get competent investment advice when the trustee knows he is not qualified to make serious investment decisions, these actions might be reckless.

At least one Court in the United States Bankruptcy Court for the Southern District of Alabama has agreed with the First Circuit's view of the necessary intent, holding that innocent or mistaken activity will not be sufficient for a debt to be nondischargeable as a defalcation, nor will negligent behavior. However, reckless behavior is sufficient to constitute a defalcation. *See Fidelity & Deposit Co. of Md v. Pierce*, Case No. 03-13249-MAM-7, Adv. No. 03-01138 (Mahoney, Margaret A.). The Court in *Pierce* concluded that this view was appropriate because including negligent defalcation as a § 523(a)(4) debt would prevent discharge of debts in situations that are not of the serious nature as the other debts covered by § 523.

<u>ATTORNEY'S FEES</u>

A significant concern in determining whether to pursue the non-discharge of an indebtedness is the recovery of attorney's fees and costs incurred in the process. A debtor who loses the argument that her indebtedness is non-dischargeable may argue that only the actual loss, and not the attorney's fees incurred by the surety or insurer, should be declared non-dischargeable. The Eleventh Circuit has ruled that attorney's fees resulting from a creditor's actions to collect its debt are nondischargeable if a contract or statute provides for the award of fees. *See TranSouth Fin. Corp. of Florida v. Johnson* case, 931 F.2d 1505 (11th Cir. 1991) There is, however, a split of authority among the courts on this issue. *See Beneficial Nat'l Bank v. Priestley*, 201 B.R. 875, 886-87 (Bankr. D.Del. 1996).

In *TransSouth*, a payee on a promissory note filed an adversary proceeding to except from discharge the debtors' liability on the note. The debtors agreed that the debt was nondischargeable pursuant to 11 U.S.C. § 523(a)(2) as fraudulently obtained and further stipulated that the attorney's fees and costs incurred by the payee, as provided by the note between the parties, were nondischargeable. The Bankruptcy Court, however, refused to award the payee its attorney's fees and costs. The Eleventh Circuit vacated the ruling of the Bankruptcy Court, holding that a successful creditor may recover its attorney's fees as part of a non-dischargeable debt if such fees are provided for by contract.

In reaching this decision, the Eleventh Circuit reasoned that § 523 of the Bankruptcy Code does not discharge an individual debtor from "any debt" that meets the requirements of § 523. A "debt" is defined as "liability on a claim." *See* 11 U.S.C. § 101(11). A "claim" is defined as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(4)(A). The Eleventh Circuit reasoned that a "debt" excepted from discharge by § 523 would include any contractual attorney's fees associated with the debt. The fees were a part of the entire "debt" owed. The Eleventh Circuit further explained that allowing contractual fees and costs to be nondischargeable does not violate the "fresh start" policy of the Bankruptcy Code, which is designed to protect the honest debtor. A debtor attempting to abuse the proceedings of bankruptcy is not entitled to the complete medley of Bankruptcy Code protections. "Fraudulent conduct is best discouraged, not only by denying discharge, but also by . . . [recognizing that] the creditor who has been defrauded is entitled to all of its rights under the contract, including reasonable attorneys fees." *TransSouth*, 931 F.2d at 1509-10 (quoting *In re Sears*, 102 B.R. 781, 785 (Bankr. S.D.Cal. 1989)); *see also Chase Manhattan Bank v. Birkland*, 98 B.R. 35, 37 (Bankr. W.D. Wash. 1988).

CLAIMS BY COMMERCIAL SURETIES

There are several reported decisions addressing claims by commercial sureties pursuing claims of non-discharge against debtors in bankruptcy. Many of these cases involve claims by sureties on probate and fiduciary bonds where the debtor was the principal on the bond:

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

Theodore C. Richardson was appointed trustee over a judicially created trust and was authorized to sell certain property for distribution to the beneficiaries. Old Republic Surety Company, as surety, issued two bonds on Richardson's behalf guaranteeing his obligations as trustee. Richardson sold the property, but failed to deposit and secure all of the proceeds of the sale. Instead, Richardson paid most of the sales proceeds to himself, under the erroneous belief that he was entitled to these funds as a compensation for his services as trustee. When Richardson failed to comply with a court order to return the money to the trust, a judgment entered against him and Old Republic, as surety. Old Republic satisfied the judgment and obtained a judgment against Richardson for its loss. *In re Richardson*, 178 B.R. at 21.

Thereafter, Richardson filed a petition for Chapter 7 relief in the United States Bankruptcy Court for the District of Columbia. Old Republic filed a proof of claim with the Bankruptcy Court. The proof of claim explicitly stated that the claim was based on subrogation and that, in this capacity, it was asserting the claim as subrogee of the trust beneficiaries. Old Republic also filed an adversary proceeding against Richardson seeking a determination its judgment against Richardson was non-dischargeable pursuant to 11 U.S.C. §523(a)(4). The surety's complaint, like its proof of claim, asserted claims sounding in subrogation based on the rights of the trust beneficiaries. No direct claim for reimbursement was asserted.

Richardson raised the following defenses to the surety's claim: (1) Old Republic could not proceed with a claim for subrogation because it chose to proceed with a claim for reimbursement; (2) Old Republic could not proceed with a claim for subrogation because it could not show the existence of a fiduciary relationship between Old Republic and Richardson; and (3) even if Old Republic could proceed with a claim of subrogation, it could not prove a defalcation because Richardson was at most guilty of negligence in connection with his conduct as trustee. The Bankruptcy Court rejected each of these arguments. *In re Richardson*, 178 B.R. 19 (Bankr.D.C. 1995).

With respect to Old Republic's standing as subrogee, the District Court noted that Bankruptcy Code §509(a) specifically recognizes the concept of subrogation for sureties. Section 509(b) provides that a surety's subrogation rights will not be recognized where it has an allowed claim for reimbursement or contribution against the debtor. This rule exists to prevent double recovery by the surety. In addition, subrogation will not be permitted where the subrogee received the consideration for the original claimant's claim. Richardson argued that Old Republic had forfeited its subrogation rights by asserting a claim for reimbursement against

Richardson. The District Court rejected this argument, noting that both Old Republic's proof of claim and its non-discharge complaint asserted claims sounding in subrogation and not reimbursement. *See In re Richardson*, 193 B.R. 378. The Bankruptcy Court also concluded that Old Republic was entitled to assert claims as the surbogee of the beneficiaries because it did not pay the claim as a volunteer, but rather as an obligor under the state court judgment.

Richardson next claimed that Old Republic could prove a non-dischargeable debt for fraud or defalcation under § 523(a)(4) only by demonstrating that a fiduciary relationship existed directly between Old Republic and Richardson. The Bankruptcy Court rejected this argument, reasoning that subrogation requires a determination as to whether a fiduciary relationship existed between Richardson and the beneficiaries trust, not between Richardson and Old Republic. Moreover, if allowed, Richardson's claim would subvert the policy of the Bankruptcy Code's exceptions to discharge, since a debtor could defeat a claim for nondischarge in every case simply by allowing the surety to pay the claim and then filing a bankruptcy petition. *See In re Richardson* 178 B.R. at 23.

Having concluded that Old Republic was subrogated to the beneficiary's claims against Richardson, the Bankruptcy Court next turned to the issue of whether Richardson's conduct constituted defalcation under section 523(a)(4). Richardson argued that he was at most guilty of negligence, in that he mistakenly believed that the law allowed him to pay himself the proceeds of the sales as his fee. The Bankruptcy Court rejected this argument, concluding that an intentional unauthorized transfer of funds constituted a defalcation, even if the debtor was acting under a mistake of law. Specifically, the Bankruptcy Court held that "[i]gnorance of the law should be no excuse to defalcation, whether due to negligence or not, where that ignorance leads to a fiduciary default." *In re Richardson*, 178 B.R. at 29. In its analysis, however, the Bankruptcy Court left open the possibility that a debtor acting merely negligently or with some mistake of fact will could be entitled to discharge. *In re Richardson*, 178 B.R. at 32-3.

In *In re Swanson*, 231 B.R. 145 (D.N.H. 1999), a surety obtained a non-discharge of a judgment against a former guardian over a minor's Estate. Donna Sherrell Swanson was appointed guardian over the Estate of Melissa Sue Swanson, a minor. Peerless Insurance Company, as surety, issued a bond on her behalf as guardian over the Estate. On January 24, 1996, the Probate Court entered a Decree in which Swanson was found to have misappropriated assets in the amount of $65,000.00. Peerless satisfied its obligations to the Probate Court under its bond and pursued Swanson for reimbursement. Swanson filed a petition for Chapter 7 relief in the United States Bankruptcy Court for the District of New Hampshire.

Peerless filed an adversary proceeding against Swanson in the Bankruptcy Court seeking to have its judgment declared exempt from discharge. The Bankruptcy Court agreed, holding that a court appointed guardian constitutes a "fiduciary" under 11 U.S.C. §523(a)(4). The Bankruptcy Court further held that that the indebtedness giving rise to surety's judgment was the result of a fraud or defalcation. In reaching this decision, the Bankruptcy Court noted that defalcation "includes innocent as well as intentional or negligent default so as to reach the conduct of all fiduciaries who are short in their accounts." *In re Swanson*, 231 B.R. at 148 (*quoting In re Misiaszek*, 162 B.R. 80, 82 (Bankr.D.N.H. 1993)). As such, for Peerless to satisfy its burden of proof the Bankruptcy Court concluded that the surety need only prove "that a fiduciary failed to return property or account for same, even though no fraud, embezzlement,

or even misappropriation on the part of the fiduciary is shown." I*n re Swanson*, 231 B.R. at 149 (*quoting In re Reeves*, 124 B.R. 5, 6 (Bankr.D.N.H. 1990)).

A similar result was reached by the United States Bankruptcy Court for the Southern District of New York in *In re Daly*, 247 B.R. 369 (Bankr.S.D.N.Y. 2000). In that case, Kenneth L. Daly was found to have engaged in self-dealing while acting as personal representative of an Estate. Western Surety Company, which had issued a bond on Daly's behalf as personal representative, incurred a loss after Daly failed and refused to reimburse certain funds to the Estate as directed by the Probate Court. After Daily filed a petition for Chapter 7 relief, Western filed an adversary proceeding against him seeking to exempt his debt from discharge under 11 U.S.C. §523(a)(4). On cross motions for summary judgment, the Bankruptcy Court concluded that Daly's debt to Western was exempt from discharge.

In opposing Western's motion for summary judgment, Daly argued he had been guilty of negligence in his administration of the Estate, but that there had been no finding of a breach of fiduciary duty or any finding sufficient to constitute defalcation. Although the Bankruptcy Court acknowledged a split in authority as to what conduct is necessary to support a finding of defalcation, it ultimately concluded that defalcation under 11 U.S.C. §523(a)(4) required more than a finding of negligence. *In re Daly*, 247 B.R. at 380. The Bankruptcy Court did not, however, set forth a clear definition of the term. Instead, the bankruptcy court examined the decision of the Probate Court and determined that there were sufficient findings that Daly's conduct in the Estate rose above mere negligence.

In *In re Barnes*, 317 B.R. 187 (Bankr.M.D.Ga. 2004), a surety on a guardianship bond pursued a non-discharge action against the former guardians over a minor's Estate. The guardians, who were the parents of the minor child, had been appointed to administer funds which had been awarded to the child from a medical malpractice claim. In was undisputed that the guardians had used a portion of the funds to open a hardware store, which had ultimately gone out of business. Pennsylvania Mutual Casualty Insurance Company, as surety, sustained a significant loss under its bond.

The guardians eventually filed a petition for Chapter 7 relief. The surety filed an adversary proceeding objecting to the discharge of the indebtedness, claiming that the debt arose from the defalcation of the guardians while acting in a fiduciary capacity. The surety then moved for summary judgment. After concluding that the guardians had been acting as fiduciaries under 11 U.S.C. §523(a)(4), the Bankruptcy Court considered whether the debt arose from a defalcation. In its analysis, the Bankruptcy Court set forth the general rule that defalcation did not necessarily require proof of fraud. *Barnes*, 317 B.R. at 190-91 (*quoting Quaif v. Johnson*, 4 F.3d 950, 953 (11th Cir. 1993)). The Bankruptcy Court concluded, however, that a genuine issue of material fact existed as to whether the guardians' conduct constituted defalcation under 11 U.S.C. §523(a)(4), which precluded the entry of summary judgment as to that issue.

In *In re Yanke*, 225 B.R. 428 (Bankr.D.Minn. 1998), Bruce D. Yanke was appointed guardian over the Estate over the Estate of a minor. Minnesota Trust Company of Austin, as surety, issued a bond on his behalf as guardian over the Estate. After the minor reached the age of majority, Yanke was found to have misappropriated certain assets of the Estate. Specifically, Yanke was found to have overcompensated himself for his duties a guardian and to have expended funds from the Estate in excessive amounts and for inappropriate and

unreasonable purposes. After an unsuccessful appeal, the surety filed suit against Yanke to recover all funds it had paid to the Estate to settle the claim. During the pendency of this lawsuit, Yanke filed for bankruptcy.

The surety commenced an adversary proceeding against Yanke seeking to have the indebtedness declared non-dischargeable under 11 U.S.C. §523(a)(4), Both parties moved for summary judgment. In ruling for the surety, the Bankruptcy Court first rejected the argument that §523(a)(4) requires the existence of a fiduciary relationship between the principal and surety. Rather, by virtue of the surety's subrogation rights, the surety steps into the shoes of the Estate and can rely upon the fiduciary relationship which had existed between Yanke and the minor. The Bankruptcy Court next concluded that the decision and findings of the probate court would be accorded collateral estoppel effect. As such, having been given a full and fair opportunity to litigate the breach of fiduciary duty issues in the probate court, the bankruptcy court ruled that Yanke was precluded from re-litigating whether his conduct constituted a breach of his fiduciary obligations. The Bankruptcy Court further noted that "[o]ne the pre-existing and objectively manifested fiduciary relationship contemplated by §523(a)(4) is established, a ' defalcation' is proven by the simple failure to meet duties imposed by non-bankruptcy law." *In re Yanke*, 225 B.R. at 437 (*citing In re Cochrane*, 179 B.R. 628, 635 (Bankr.D.Minn. 1995)).

CLAIMS BY FIDELITY INSURERS

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

In re Graziano, 35 B.R. 589 (Bankr. E.D.N.Y. 1983), a fidelity insurer pursued a non-discharge claim after it had paid its insured on a loss. In that case, the insured was a fruit wholesaling company that was covered by a fidelity bond issued by Great American Insurance Company. Robert W. Graziano was an employee of the insured and was responsible for over-the-counter sales to customers. Graziano engaged in a scheme to give discounted prices to a trade association of Korean retailers, which was not disclosed to his employer. The insured later suspected Graziano was engaged in unauthorized activities and hired an accountant to investigate. The accountant determined that $775,000 in monies were missing. Criminal charges were filed against Graziano and he ultimately pled guilty to grand larceny. The insured made a claim against Great American, which result in a penal sum loss under the fidelity bond. After Graziano filed a petition for Chapter 7 relief., Great American commenced an adversary proceeding against him seeking a declaration that its claim was exempt from discharge because it was based on embezzlement or larceny. *In re Graziano*, 35 B.R. at 593.

In the adversary proceeding, Great American argued that Graziano's plea of guilty to larceny precluded him from arguing that his conduct did not rise to the level of embezzlement or larceny under § 523. The Court disagreed and found that the criminal conviction did not preclude Graziano from litigating these issues in the context of the non-discharge action. In reaching this decision, the Bankruptcy Court found that there had been no actual litigation of any issue in the criminal proceeding. Graziano's guilty plea was entered at his arraignment

and the state had never presented its case. As such, no issues had been actually litigated in the prior criminal case. *In re Graziano*, 35 B.R. at 595-56. The Bankruptcy Court did rule, however, that the criminal conviction could be used as evidence by Great American, but would not be treated as conclusive evidence of larceny or embezzlement.

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

A fidelity insurer was held to be entitled to a non-dischargeable debt against a dishonest employee in *In re Hutcherson*, 50 B.R. 845 (Bankr. E.D.Va. 1985). National Union issued a crime policy in favor of its insured, Robertshaw Controls Company. Edward Hutcherson, who was employed as the chief accountant of Robertshaw, admitted that he had embezzled $147,307 from the company. Hutcherson was charged and later pleaded guilty to grand larceny in connection with the embezzlement. Robertshaw asserted a claim against National Union on its crime policy, which had a $50,000 deductible. National Union paid Robertshaw $97,307, reflecting the total loss less the deductible. In exchange for the payment, National Union received an assignment of Robertshaw's claims against Hutcherson. The policy also expressly provided that National Union would be subrogated to Robertshaw's rights of recovery against any person. *In re Hutcherson*, 50 B.R. at 847.

Hutcherson filed a Chapter 7 bankruptcy petition in which National Union was listed as a creditor in the schedules. National Union commenced an adversary proceeding alleging that the debt was not dischargeable under 11 U.S.C. §523(a)(4) because it arose from embezzlement or larceny. Hutcherson stipulated that he had stolen the money, but claimed that National Union could not pursue a non-discharge action because the insurer was not a direct party to the embezzlement. Hutcherson argued that only Robertshaw, as his former employer, could pursue such a the claim. Specifically, Hutcherson argued that a claim of nondischargeability "is personal to the party from whom the property was embezzled and the right to assert a dischargeability complaint cannot be maintained by a subrogated insurer who has made payment on the claim." *In re Hutcherson*, 50 B.R. at 850. The Court rejected Hutcherson's arguments and concluded that National Union had standing to pursue a claim for non-discharge. The Court relied largely on case law from Virginia for the proposition that a subrogated insurer stands in the shoes of its insured for the purpose of pursuing claims which the insured would have had against third parties. *In re Hutcherson*, 50 B.R. at 852.

In *In re Shinew*, 33 B.R. 588 (Bankr. N.D.Ohio 1983), the debtor was a former employee of a newspaper who engaged in a scheme of proceeds of contests which had been offered by the newspaper to its readers. After the debtor pleaded guilty to charges of grand theft in connection with the scheme, the newspaper made a claim against Great American Insurance Company, its fidelity insurer. Great American paid the limits of its policy, which expressly provided that, upon payment, Great American would be subrogated to the newspaper's rights of recovery against third parties. *In re Shinew*, 33 B.R. at 590.

When the debtor filed for bankruptcy, Great American and the newspaper commenced adversary proceedings seeking to have their claims against the debtor exempt from discharge. Great American claimed that the debt was non-dischargeable under 11 U.S.C. §523(a)(4) as embezzlement, larceny or fraud while acting as a fiduciary. The Court held that the evidence supported a non-dischargeable judgment in favor of Great American based on theories of either larceny or embezzlement. In reaching this decision, the Court relied heavily upon the fact that the debtor had admitted to misconduct in connection with the contest and had pleaded guilty to criminal charges. *In re Shinew*, 33 B.R. at 592.

PRACTICAL CONSIDERATIONS

A fidelity insurer or commercial surety considering these issues must weigh the risks against the potential rewards of pursuing the non-discharge of a certain indebtedness. The rewards of securing a non-discharge of an indebtedness can be significant. A non-dischargeable judgment gives the fidelity insurer or commercial surety considerable leverage in negotiating a settlement with the debtor. The surety or insurer's position can be especially strong since most, if not all, of the debtor's pre-bankruptcy debts have been discharged.

The decision, however, is primarily one of economics: Having pursued the debtor into bankruptcy, how much more money is the fidelity insurer or commercial surety willing to spend pursuing the non-discharge of an indebtedness that may never be collected? While this risk is always present in the salvage analysis, it is especially relevant in bankruptcy because the debtor is presumptively insolvent.

In considering its options, a fidelity insurer or commercial surety should weigh the following:

- Remember that the Bankruptcy Code and Rules are designed to give debtors a "fresh start," and therefore, a presumption exists in favor of dischargeability of debts. On the other hand, a discharge is a privilege afforded to debtors, and most Bankruptcy judges will consider all the facts and circumstances and otherwise provide a fair hearing before deciding discharge issues.

- The deadline for objecting to a debtor's discharge will be strictly enforced by the Bankruptcy Court. Whether or not formal notice of the bankruptcy filing is received, the deadline for objecting to the discharge will be binding if actual notice was given by whatever means.

- Certain issues previously litigated with the debtor may have to be addressed and litigated again. In considering non-bankruptcy judgments, Bankruptcy Courts often do not apply res judicata or collateral estoppel principles.

- The burden of proof in a non-dischargeability action is high with respect to embezzlement, there must be clear and convincing evidence, according to some court. Thus, the fact that a judgment was obtained against the debtor in a non-bankruptcy action does not automatically mean the debt will be non-dischargeable under the Bankruptcy Code.

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