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**WHEN YOUR PRINCIPAL'S "OOPS" TURN OUT TO BE
"DUPES":
OBJECTING TO DISCHARGE IN BANKRUPTCY**

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Introduction

The surety industry has been enjoying a relatively pain free existence as of late.¹ However, with the recent crunch in the credit markets and the downturn in the new home sales, it is likely that we are on the brink of entering a different part of the cycle. Projects long in the making will continue as planned, financing will run short, sales will not be what was expected and more projects will fail. On the fidelity front, as investment capital and credit become harder to come by, some will tap into sources of money that belong to others. Given the inevitability of the coming of the loss portion of the cycle, sureties will need to focus more attention and perhaps invest more in the pursuit of indemnity. Sureties who have been used to chasing indemnitors into bankruptcy and then sitting back to see what turns up may need to adjust their approach and get involved in the bankruptcy by objecting to discharge of the debtor. The purpose of this paper is to give you an overview of the nature of discharge in bankruptcy, reasons for objecting to discharge and practical considerations for determining whether to stop at the doors of the bankruptcy court or venture inside and fight on. Neither this paper, nor the associated speech, is meant to be an exhaustive study on discharge or suitable as stand alone guidance. Many of the reasons for objecting to discharge unrelated or marginally related to surety matters will receive little or no treatment. Our purpose is to provide you with an overview and rudimentary understanding to make you aware of issues you should investigate and possibly raise with your own legal counsel and/or bankruptcy counsel. As with many legal issues, each Circuit and each court for that matter may reach different conclusions based on the same or similar facts. One last qualification before we begin our discussion: While there is a discharge associated with Chapter 11 and Chapter 13, this paper will focus more on Chapter 7 bankruptcies which in our experience are the type of bankruptcies most frequently encountered in a construction surety context. Given the dollar amounts at play on bonded projects and contractors general insistence to resolve all of the problems they can within their own power before their surety (and personal indemnity) become involved, the types of losses that typically occur have usually stripped a company of its ability to operate and have outdistanced an individual's ability to repay the surety. As such, there is generally little incentive or ability to attempt anything short of total liquidation.

Discharge

The granting of a discharge in a Chapter 7 bankruptcy case invokes certain permanent protections for the benefit of an individual debtor. *In re Shultz*, 251 B.R. 823, 827 (Bankr. E.D. Tex. 2000). It discharges the debtor "from all debts that arose before the date of the order for relief under this chapter..." *Id.* (quoting 11 U.S.C.A. § 727(b) (Vernon 1993)). The discharge also "...voids any judgment at any time obtained, to the extent that such judgment is a

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determination of the personal liability of the debtor with respect to any debt discharged under section 727...of this title, whether or not discharge of such debt is waived.” *Shultz*, 251 B.R. at 827 (quoting 11 U.S.C.A. § 524(a)(1) (Vernon 1993)). It further “...operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect recover or offset any such debt as a personal liability of the debtor....” *Shultz*, 251 B.R. at 827 (quoting 11 U.S.C.A. § 524(a)(2)). These statutes effectuate the “fresh start” ideals that underlie the Bankruptcy Code with respect to pre-petition liability of the debtor. *Shultz*, 251 B.R. at 828. The discharge of a debtor does not, however, relieve potential obligations of third parties.

Federal law provides that discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt. 11 U.S.C.A. § 524(e). In addition, there has been a uniform agreement among courts that discharge injunctions do not prevent creditors from determining the liability of a debtor as a prerequisite to recovering in further actions monetary recovery from third parties. *In re Greenway*, 126 B.R. 253, 254 (Bankr. E.D. Tex. 1991).

This general consensus was later endorsed by the Fifth Circuit. *See generally Houston v. Edgeworth*, 993 F.2d 51 (5th Cir. 1993). In that case, the Court considered whether medical malpractice plaintiffs should be allowed to pursue a lawsuit against a doctor in order to collect proceeds from his malpractice liability policy, despite the doctor’s discharge injunction. The Court ultimately held that § 524(e) excludes the liability insurance carrier from the protection of bankruptcy discharge.² *Id.* at 53. They felt that this interpretation was grounded in both textual and equitable foundations. *Id.* at 54. The Fifth Circuit believed that it would not make any sense to allow an insurer to escape coverage for injuries caused by its insured merely because the insured receives a bankruptcy discharge. *Id.* They added the “fresh start” policy of the Bankruptcy Code was not intended to provide a method by which an insurer can escape its obligations based simply on the financial misfortunes of the insured because such a result would be fundamentally wrong. *Id.*

Thus, courts have consistently held that the “fresh start” of Chapter 7 is intended to apply only to debtors and is not intended to provide a mechanism for insurers to escape liability. *Shultz*, 251 B.R. at 829 (quoting *In re Farley*, 194 B.R. 553, 555 (Bankr. S.D.N.Y. 1996)). So while the insurer may dispute in another forum whether it had any duty to the debtor, it cannot legitimately use the discharge defenses endowed upon a debtor by the Bankruptcy Code to shelter itself from liability. *Id.* at 829. In short, a surety should not be discouraged from looking toward third party sources of recovery such as an insurance policy simply because a debtor has filed for Bankruptcy protection.

Procedure for Contesting Dischargeability

To contest dischargeability, under 523(c) you must file an objection to the discharge “not later than 60 days following the first date set for the meeting of creditors held pursuant to §

² In the liability insurance context, a tort plaintiff must first establish the liability of the debtor before the insurer becomes contractually obligated to make any payment. *Edgeworth*, 993 F.2d at 53-54.

341(a)." Fed.R. Bankr. P. 4007(c). A motion to extend the 60-day period must be made prior to the end of the period and must be made by the creditor. Fed. R. Bankr. P. 9006(b)(3) permits an enlargement of time. "In a chapter 7 liquidation case a complaint objecting to the debtor's discharge under § 727(a) of the Code shall be filed no later than 60 days after the first date set for the meeting of creditors under § 341(a)." ³ "In a chapter 11 reorganization case, the complaint shall be filed not later than the first date set for the hearing on confirmation" ⁴ If you have actual notice of the bankruptcy you must take reasonable steps to ascertain the bar date otherwise you lose the right to object. In re Sam, 894 F.2d 778 (5th Cir. 1990); In re Rhodes, 61 B.R. 626 (Bankr. 9th Cir. Cal. 1986).

Reasons for Objecting to Discharge

There are two basic types of objection to discharge. First there is an objection to discharge of the debtor altogether. This type of objection is usually the result of some bad behavior on the part of the debtor relating to the bankruptcy process itself. "Bankruptcy process" is used loosely here to mean the process of becoming insolvent and eventually filing bankruptcy. (One of the reasons for objecting to discharge is a fraudulent transfer which could in some cases pre-date a bankruptcy filing by a year). This essentially follows the notion that bankruptcy protection should not be given to the dishonest bankrupt. This type of discharge is found both in the context of a Chapter 7 (total liquidation) and reorganization. ⁵ Behavior that supports this type of objection is discussed more fully below and in the surety context will be things such as fraudulent transfers, hiding assets, failing to schedule assets, etc. Second, there is an objection to the discharge of specific debts. This type of objection is found at 11 USC 523. This type of objection is not necessarily associated with the bankruptcy process, but rather fraudulent conduct relating to an underlying debt (Such as the granting of surety credit, a decision to finance a principal, etc.).

Discharge of the Debtor under 727

Under section 727 of the Bankruptcy Code, there are several instances where a debtor's discharge may be denied. See 11 U.S.C.A. § 727 (a)(1)-(a)(9). Specifically, a court will not grant the debtor a discharge where:

"(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--

³ Federal Rules of Bankruptcy Procedure 4004(a).

⁴ *Id.*

⁵ 11 USC 727; 11 USC 1328

- (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 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), (5), or (6) of this subsection, on or within one year before the date of the filing of 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 six 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..."

11 U.S.C.A. §727(a)(1)-(a)(9).

Denial of Discharge under § 727(a)(2)(A) – FRAUDULENT TRANSFERS

The purpose of § 727(a)(2)(A) "is to deny a discharge to those debtors who, *intending to defraud*, transfer property which would have become property of the bankrupt estate." *In re Lee*, 309 B.R. 468, 481 (Bankr. W.D. Tex. 2004) (quoting *Pavy v. Chastant (In re Chastant)*, 873 F.2d 89, 90 (5th Cir. 1989)) (emphasis in original). A party objecting to a discharge under § 727(a)(2)(A) must prove that there was: "(1) a transfer of property; (2) belonging to the debtor; (3) within one year of the filing of the petition; (4) with actual intent to hinder, delay or defraud a creditor." *Lee*, 309 B.R. at 481; *In re Dennis*, 330 F.3d 696, 701 (5th Cir. 2003). "The bankruptcy court's determination that a debtor did or did not have the requisite intent to hinder, delay or defraud is a factual finding." *Lee*, 309 B.R. at 481. The objecting party bears the burden of proving the debtor's intent to defraud. *Id.*; see *Chastant*, 873 F.2d at 90-91. Evidence of actual intent to defraud creditors is required to support a finding sufficient to deny a discharge and constructive intent is insufficient. *Lee*, 309 B.R. at 481; *Chastant*, 873 F.2d at 91.

Additionally, actual intent may be inferred from the debtor's actions and may be shown by circumstantial evidence. *Dennis*, 330 F.3d at 701-02. The courts have identified several factors or "badges of fraud" that tend to prove actual intent to defraud: "(1) the lack or inadequacy of 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 financial condition of the party sought to be charged both before and after the transaction in question; (5) the existence or cumulative effect of the 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." *Id.* at 702. While one of these factors is sufficient to find fraudulent intent, the accumulation of several factors indicates strongly that the debtor possessed the requisite intent. *In re Lightfoot*, 152 B.R. 141, 148 (Bankr. S.D. Tex. 1993).

There have been several cases where a creditor objected to a debtor's discharge when the debtor converted nonexempt property into exempt property before filing a bankruptcy petition. For example, in *In re Reed*, the Fifth Circuit held that "while pre-bankruptcy conversion of nonexempt into exempt assets is frequently motivated by the intent to put those assets beyond the reach of creditors, which is, after all, the function of an exemption, evidence of actual intent to defraud creditors is required to support a finding sufficient to deny a discharge." *In re Reed*, 700 F.2d 986, 991 (5th Cir. 1983). In that case, Reed sold his personal assets and applied the proceeds to reduce the mortgages on his family residence. He raised approximately \$35,000 and applied \$30,000 to his second mortgage home improvement loan and applied the balance of about \$15,000 to reduce the first mortgage on his home. There was also a question of whether most of the sales were below the market value for the items. Reed also diverted daily receipts from a business into a separate account unknown to his creditors. Using these facts, the court found that the evidence supported the finding that Reed had the actual intent to defraud his creditors. *Id.* The court also acknowledged that Reed's pattern of conduct evinced that intent. *Id.* The court pointed out that Reed rapidly converted his non exempt assets to reduce his mortgages after arranging with his creditors that he be free from payment obligations until the following year. *Id.*

However, the Fifth Circuit has also granted a discharge where the debtor sold assets in order to pay off a mortgage because there was no evidence of intent to delay or hinder creditors. *In re Bowyer*, 932 F.2d 1100, 1103 (5th Cir. 1991). In that case, Bowyer's wife withdrew \$24,000 from their savings account and paid it on their homestead mortgage approximately fifteen days before filing for bankruptcy. They also sold assets in order to repair their residence. In examining the facts, the court cited the well settled rule that "the mere conversion of non-exempt property into exempt property on the eve of a bankruptcy was not of itself such fraud as will deprive the bankrupt of his right to exemptions." *Id.* at 1102. The court also quoted House and Senate reports where it was stated that "the debtor will be permitted to convert non-exempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law." *Id.* (citing H.R. Rep. No. 595, 95th Cong., 1st Sess. 361 (1977), reprinted in 1978 U.S. Code Cong. & Admin. News 5963, 6317 (citation omitted); S. Rep. No. 989, 95th Cong., 2d Sess. 76 (1978), reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 5862)). However, the court noted that the conversion of assets may be relevant where other evidence proves actual intent to defraud creditors. *Bowyer*, 932 F.2d at 1102 (citing *Reed*, 700 F.2d at 991). The *Bowyer* court then distinguished their facts from *Reed* because they felt that Bowyer's conduct was not as egregious as Reed. *Bowyer*, 932 F.2d at 1102. The court also pointed out that the creditor made no specific argument to the court that Bowyer's transfers were made with the intent to hinder or delay. *Id.* For these reasons, the court held that Bowyer's \$24,000 payment from non-exempt savings on his exempt homestead was legitimate pre-bankruptcy planning. *Id.* at 1102.

Two essential points emerge from the *Bowyer* case: (1) the essential finding of actual intent arises from facts independent of the simple act of converting nonexempt into exempt assets; and (2) that inquiry is, in turn, dependant on the credibility determinations of the trial judge. *Lee*, 309 B.R. at 483. Thus, when a debtor elects to liquidate a given asset, and to use the proceeds to satisfy a claim on exempt assets rather than to satisfy other claims, the debtor has not committed fraud. *Id.* The decision to prefer one creditor over another always of necessity hinders or delays payment to other creditors, but is not, as a matter of law, fraudulent in and of itself. *Id.*

Similarly, some courts have had to determine whether a discharge should be denied because of transactions involving a debtor's family members. For example, the Fifth Circuit in *In re Swift* affirmed a district court's finding that a discharge should be denied. *In re Swift*, 3 F.3d 929, 931 (5th Cir. 1993). In that case, the court felt that several transactions were not innocent pre-bankruptcy planning. *Id.* at 930. Although pre-bankruptcy planning is acceptable, the line between legitimate planning and intent to defraud is not always clear. *Swift*, 3 F.3d 931. The transactions made by Swift, which were all done within a couple of months before bankruptcy, included: (1) prepaying \$5,000 in alimony or property settlement to an ex-wife; (2) using estate funds to prepay the remaining amount on a vehicle; (3) underreporting certain insurance renewal commissions; (4) transferring insurance policies to his son, who, after borrowing against them, transferred the funds to Swift's ex-wife, who then loaned the funds back to Swift; (5) borrowing money from a daughter in exchange for a promissory note, secured by some of Swift's assets. The court acknowledged that nearly every asset in Swift's estate had been tampered with before bankruptcy. *Id.* at 931.

For these reasons, the court held that Swift had the intent to hinder, defraud, delay, or conceal estate assets from his creditors. *Id.*; see also *In re Baughman*, 58 B.R. 967 (Bankr. S.D. Tex. 1986)(finding that transfers to friends or relatives in circumstances such as those which surrounded the transfers made by the debtor in this case, carry with them a presumption of fraudulent intent, which the debtor is required to rebut).

Additionally, the court in *In re Lee* compared and distinguished the *Reed*, *Bowyer*, and *Swift* case. *Lee*, 309 B.R. at 485-86. They did so because a given fact pattern, does not by itself establish fraudulent intent. *Id.* at 485. All of the nuances of the evidence in a case can dramatically effect the ultimate finding. *Id.* In analyzing the cases, the court stated:

"in *Reed* and *Swift*, the debtor was found not to have been candid with the trustee, the creditors and the court in the bankruptcy case itself, trying, for example, to hide transfers. In *Bowyer*, by contrast, the debtor was candid in his schedules as well as at the first meeting of creditors. Also, in *Reed*, the debtor apparently tried to disguise his conduct prebankruptcy so that creditors would not be able to see what he was doing. Again, in *Bowyer*, the debtor simply took money out of a nonexempt bank account, and used it to make repairs to his exempt homestead, without artifice, and apparently not in contemplation of the later bankruptcy filing."

Id. at 485-86. Using those distinctions, the *Lee* court found that the Lees did not intentionally hinder, delay, or defraud their creditors when they liquidated investment funds in order to pay off their mortgage. *Id.* at 486. The court felt that the Lees' actions were direct, undisguised, and candid. *Id.* Objecting to a discharge under § 727(a)(2) gives the creditor the burden of proving actual fraudulent intent by extrinsic evidence. This analysis is fact sensitive and evidence of intent is crucial.

Denial of Discharge under § 727 (a)(5) – LOSS OF ASSETS

Section 727(a)(5) states, as a ground for denial of discharge, that 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. 11 U.S.C.A. § 727(a)(5).

The burden of proof rests with the party objecting to the discharge. *Lee*, 309 B.R. at 478; see *Reed*, 700 F.2d at 992. Thus, the creditors have the burden of proof, and the ultimate burden of persuasion to prove by a preponderance of the evidence that the discharge should be denied. *Lee*, 309 B.R. at 478; see *Reed*, 700 F.2d at 992-93.

However, a creditor's mere allegation that there is a lack of an adequate explanation for the loss of assets does not make the prima facie case. *Lee*, 309 B.R. at 478. The creditors must prove which assets are missing to make a prima facie case. *Id.* If the objecting creditors can make out the prima facie case regarding the loss of assets, the burden then shifts to the debtors to provide a satisfactory explanation for that loss. *Id.* If a debtor's explanation is that his cash assets were dissipated, but lacks documentation, corroboration, or substantiation of such claimed losses, a court could justifiably conclude that that evidence is not sufficient to explain the loss. *Id.* An explanation that is vague and unsupported, albeit convenient, is not satisfactory. *Id.*

Satisfactory has been held to mean "reasonable, or it may mean that the court, after having heard the excuse, the explanation, has that mental attitude which finds contentment in saying that he believes the explanation--he believes what the bankrupts say with reference to the disappearance or shortage." *Reed*, 700 F.2d at 993 (quoting *In re Shapiro & Ornish*, 37 F.2d 403, 406 (N.D. Tex. 1929), *aff'd* 37 F.2d 407 (5th Cir. 1930) (debtors offered vague and unconvincing explanations)).

For example, in *Reed* the court affirmed the bankruptcy judge's finding that Reed's explanation for the loss of assets was not satisfactory. When asked to account for nearly \$20,000, Reed explained that he had many business and household expenses that were paid in cash, in addition to numerous gambling losses in Las Vegas. This explanation did not meet the satisfactory requirement.

Similarly, in *Lee* the creditors alleged that the Lees did not satisfactorily explain the disposition of approximately \$56,000 in cash withdrawals from their checking account. The facts showed that Mr. Lee made a series of large cash withdrawals from his investment accounts. He later explained in deposition and at trial that he used this cash to make repairs to his property, paying workmen in cash. He also added that it had been his practice for many years to keep large sums of cash on hand. The court even went on to distinguish their facts from *Reed*. The court stated that:

"There are echoes of *Reed* in Mr. Lee's explanation. Like Mr. Reed, he professes to routinely carry large amounts of cash. Like Reed, he cannot account for where all of the money went, or verify that it was used as he says it was, in this case to pay day laborers. Yet, unlike Mr. Reed, Mr. Lee was not pulling the cash out of his business. The money came from liquidating his investments, for reasons that are not necessarily linked to the pending lawsuits by these creditors, and certainly not in contemplation of bankruptcy. Mr. Lee's testimony to the effect that he spent a considerable portion of these cash withdrawals on day laborers is credible....

...

...The court finds that testimony credible, and consistent with the way some people (especially older, wealthier people who have retired) operate."

Lee, 309 B.R. at 479-80. The court then found that Lee had adequately explained what happened to the money that was withdrawn from his account, thus an action under § 727(a)(5) was not established. *Id.* at 480.

Denial of Discharge under § 727(a)(4)(A) – FALSE OATH OR ACCOUNT

Section 727(a)(4)(A) states, as a basis for denial of discharge, a finding that the "debtor knowingly and fraudulently, in or in connection with the case ... made a false oath or account." 11 U.S.C.A. § 727(a)(4)(A). "A party who objects to the debtor's discharge under this section has the burden to show by a preponderance of the evidence that: (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." *Lee*, 309 B.R. at 477; see *In re Beaubouef*, 966 F.2d 174, 178 (5th Cir. 1992); see also *Grogan v. Garner*, 498 U.S. 279 (1991). "False oaths sufficient to justify the denial of discharge under section 727(a)(4)(A) include: (1) a false statement or omission in the debtor's schedules; or (2) a false statement by the debtor at the examination during the course of the proceedings." *Lee*, 309 B.R. at 477; see *Beaubouef*, 966 F.2d at 178. "A discharge cannot be denied when items are omitted from the schedules by honest mistake." *Lee*, 309 B.R. at 477; see *Beaubouef*, 966 F.2d at 178.

However, "the existence of more than one falsehood, together with a debtor's failure to take advantage of the opportunity to clear up all inconsistencies and omissions, such as when filing amended schedules, can be found to constitute reckless indifference to the truth satisfying the requisite finding of intent to deceive." *Lee*, 309 B.R. at 477; see *Beaubouef*, 966 F.2d at 178.

Denial of Discharge under § 727(a)(4)(d) – WITHHOLDING RECORDS

Section 727(a)(4)(D) supports the denial of discharge when the 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 or financial affairs." The surety may be able to use this in the event the debtor refuses to turn over important financial records. It may be possible to leverage this section against the debtor in order to obtain evidence necessary to show the surety's entitlement to have a particular debt excepted from the bankruptcy under 11 USC 523.

Undoing A Discharge

On the request of a creditor, and after notice and a hearing, the court shall revoke a discharge if such discharge was: (1) obtained through the fraud of the debtor; and (2) the requesting party did not know of such fraud until after the granting of such discharge. 11 U.S.C.A. § 727(d)(1).

According to the terms of this section as well as the case law, a party attempting to revoke a debtor's discharge must demonstrate that: (1) the procurement of debtor's discharge was obtained through the fraud of the debtor; (2) the party requesting revocation did not know of debtor's fraud until after the granting of the discharge; and (3) grounds must be shown to

exist which would have prevented debtor's discharge had they been known. *NCNB Texas Nat'l Bank v. Hayes*, 127 B.R. 795, 797 (Bankr. E.D. Tex. 1991); see *In re Nielsen*, 383 F.3d 922, 925 (9th Cir. 2004) (finding that revocation requires that the discharge be obtained through fraud and it must be shown that but for the fraud, the discharge would not have been granted); *In re Bowman*, 173 BR. 922, 925 (B.A.P. 9th Cir. 1994) ("fraud must be proven in the procurement of discharge and sufficient grounds must have existed which would have prevented the discharge."); *In re Edmonds*, 924 F.2d 176, 180 (10th Cir. 1991) (debtor must have committed a fraud in fact, discovered after the discharge, which would have barred the discharge had it been known.).

Thus, revocation occurs because of a failure to comply with the requirements of the Bankruptcy Code which would have otherwise entitled the debtor to a discharge. *United States v Cluck*, 87 F.3d 138, 140 (5th Cir. 1996) (revoking a debtor's discharge for failing to disclose property and assets, making false statements on schedules, and transferring property with the intent to defraud creditors). It is also clear that the party moving for a revocation of discharge is charged with the burden of proving all of the facts upon which revocation is conditioned. *Hayes*, 127 B.R. at 797.

However, the court in *Hayes* acknowledged the fact that creditors often misconstrue this cause of action because creditors often fail to plead any grounds to support their complaint. *Id.* In this case, the debtor was the chief executive officer of Lone Star General Contractors, Inc., as well as an officer in Lone Star's one hundred percent owned subsidiary Equipment Unlimited, Inc. The creditor Bank alleged that on a date prior to Debtor's petition under Chapter 7, the debtor sold an asset of Equipment Unlimited and applied the proceeds of the sale to financial obligations owed jointly by Lone Star and the debtor. The Bank further alleged that the proceeds from the sale of that asset should have been applied to the debts of Equipment Unlimited and thus their allocation constituted fraud on the creditors of Equipment Unlimited. Additionally, the Bank alleged that the debts of Equipment Unlimited were also obligations of the Debtor. Therefore, the Bank argued that the debtor's use of the proceeds of the Equipment Unlimited asset to pay Debtor's own nondischargeable obligations related to Lone Star rather than the debts of Equipment Unlimited for which the debtor was also obligated, constituted the act of obtaining of a discharge through fraud and justifies the revocation of Debtor's discharge pursuant to 11 U.S.C. § 727(d)(1).

The court held that the Bank misapplied the revocation provision because:

"the fraud element of a revocation of discharge cause of action requires a proof of fraud in the procurement of a discharge. Bank's pleadings do not relate to such a proof but instead lay the factual groundwork for what would have been a highly suspect § 523 cause of action. Bank has also failed to plead whatsoever that it was unaware, until after Debtor had received his discharge, of the factual basis of this alleged fraud in the procurement of a discharge. This alone is fatal. Finally, the Court finds that Bank has not pled that absent this alleged fraud in the procurement of a discharge what grounds would exist under 11 U.S.C. § 727(a) which would have prevented Debtor from receiving a discharge in bankruptcy."

Id.

The *Hayes* court also gave two examples from other jurisdictions where the creditor misapplied the revocation provision. In *In re Jones*, 71 B.R. 682 (S.D. Ill. 1987), a creditor learned subsequent to debtors' discharge that debtors' had disposed of certain assets, within one year of the date of debtors' petition in Chapter 7, in which creditor claimed a perfected security interest. In the creditor's complaint to revoke debtors' discharge pursuant to § 727(d)(1), the creditor made general and conclusory allegations asserting fraud. In response to the complaint, the debtor filed a motion to dismiss alleging that creditor's complaint was, in fact, a complaint to determine the dischargeability of a debt pursuant to § 523. The court in *Jones* granted the debtor's motion after holding that creditor had misconstrued the fraud element of their 727(d)(1) cause of action. According to the *Hayes* court, "instead of alleging fraud on the part of the debtors in procuring their discharge the court found that the substance of creditor's allegations related more to the alleged fraud of the debtor vis-a-vis the creditor i.e. a § 523 cause of action." *Hayes*, 127 B.R. at 727. Additionally, the creditor in *Jones* failed to allege that any § 727(a) "grounds existed which would have prevented the discharge had they been known or presented in time." *Jones*, 71 B.R. at 684.

Similarly, the *Hayes* court found that the creditor in the case of *In re Perryman*, 111 B.R. 227 (Bankr. E.D. Ark.1990) repeated most if not all of the mistakes of the creditor in the case of *Jones*. In *Perryman*, the fraud alleged by creditor consisted of debtor's rescission of a reaffirmation agreement and subsequent sale of creditor's collateral in derogation of creditor's rights. As in *Jones*, the court in *Perryman* dismissed creditor's complaint because the court found that creditor had failed to allege or demonstrate fraud in the procurement of debtor's discharge as well as any grounds pursuant to § 727(a) which would have prohibited debtor's discharge. *Hayes*, 127 B.R. at 797.

Therefore, in a complaint to revoke a debtor's discharge, general allegations of fraud will not defeat a motion to dismiss. There must be some evidence of fraud in the procurement of the discharge and evidence under §727(a) that would have prevented the discharge had that evidence been known.

Timeliness

Under § 727(e), a creditor may request a revocation of a discharge under subsection (d)(1) of this section within one year after such discharge is granted. 11 U.S.C.A. § 727(e). Under the Bankruptcy Code, a creditor is an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C.A. § 101(10)(A).

Discharge of the Debtor under 523

Under section 523 of the Bankruptcy Code, there are several instances where the discharge of a specific debt may be denied. See 11 U.S.C.A. § 523. Specifically, a court will not grant the debtor a discharge:

(a)(1) for a tax or a customs duty . . .

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(B) use of a statement in writing—

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive; or

(C)

(i) for purposes of subparagraph (A)—

(I) consumer debts owed to a single creditor and aggregating more than \$500 for luxury goods or services incurred by an individual debtor on or within 90 days before the order for relief under this title are presumed to be nondischargeable; and

(II) cash advances aggregating more than \$750 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within 70 days before the order for relief under this title, are presumed to be nondischargeable; and

(ii) for purposes of this subparagraph—

(I) the terms “consumer”, “credit”, and “open end credit plan” have the same meanings as in section 103 of the Truth in Lending Act; and

(II) the term “luxury goods or services” does not include goods or services reasonably necessary for the support or maintenance of the debtor or a dependent of the debtor.

(3) neither listed nor scheduled under section 521 (1) of this title, with the name, if known to the debtor, of the creditor to whom such debt is owed, in time to permit—

(A) if such debt is not of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim, unless such creditor had notice or actual knowledge of the case in time for such timely filing; or

(B) if such debt is of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim and timely request for a determination of dischargeability of such debt under one of such paragraphs, unless such creditor had notice or actual knowledge of the case in time for such timely filing and request;

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

(5) for a domestic support obligation;

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

(7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit . . .

(8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor's dependents, for [educational loans] . . .

(9) for death or personal injury caused by the debtor's operation of a motor vehicle, vessel, or aircraft if . . . debtor was intoxicated . . .

(10) that was or could have been listed or scheduled by the debtor in a prior case concerning the debtor . . .

(11) provided in any final judgment, unreviewable order, or 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;

(12) for malicious or reckless failure to fulfill any commitment by the debtor to a Federal depository institutions regulatory agency to maintain the capital of an insured depository institution, except that this paragraph shall not extend any such commitment which would otherwise be terminated due to any act of such agency;

(13) for any payment of an order of restitution issued under title 18, United States Code;

(14) incurred to pay a tax . . . or fine or penalties imposed under Federal election law . . .

(15) to a spouse, former spouse, or child of the . . . incurred by the debtor in the course of a divorce or separation . . .

(16) for a fee or assessment that becomes due and payable after the order for relief to a membership association . . .

(17) for a fee imposed on a prisoner by any court . . .

(18) owed to a pension, profit-sharing, stock bonus, or other plan . . .

(19) . . . for . . . the violation of any of the Federal securities laws . . .

(c)(1) Except as provided in subsection (a)(3)(B) of this section, the debtor shall be discharged from a debt of a kind specified in paragraph (2), (4), or (6) of subsection (a) of this section, unless, on request of the creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge under paragraph (2), (4), or (6), as the case may be, of subsection (a) of this section.

(2) Paragraph (1) shall not apply in the case of a Federal depository institutions regulatory agency seeking, in its capacity as conservator, receiver, or liquidating agent for an insured depository institution, to recover a debt described in subsection (a)(2), (a)(4), (a)(6), or (a)(11) owed to such institution by an institution-affiliated party unless the receiver, conservator, or liquidating agent was appointed in time to reasonably comply, or for a Federal depository institutions regulatory agency acting in its corporate capacity as a successor to such receiver, conservator, or liquidating agent to reasonably comply, with subsection (a)(3)(B) as a creditor of such institution-affiliated party with respect to such debt.

(d) If a creditor requests a determination of dischargeability of a consumer debt under subsection (a)(2) of this section, and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, the proceeding if the court finds that the position of the creditor was not substantially justified, except that the court shall not award such costs and fees if special circumstances would make the award unjust.

(e) Any institution-affiliated party of an insured depository institution shall be considered to be acting in a fiduciary capacity with respect to the purposes of subsection (a)(4) or (11).

Some of these issues are surety or fidelity related and some not. Rather than discuss these issues separately, we have combined them with a general discussion of how they may arise in a surety context to give hints on where to look should a principal default or refuse to indemnify the surety under suspicious circumstances.

How Facts Giving Rise to Nondischargeability may Arise in a Surety Context and some Practical Considerations in Determining how to Proceed.

There are certain circumstances, particularly in the fidelity context where an objection to discharge is obvious and in plain view. Embezzlement, larceny, criminal restitution are all sources for objecting to discharge. Some other areas that a surety, particularly a construction bond surety, may encounter facts giving rise to an objection to discharge of a specific debt are things like fraud or defalcation of fiduciary, procuring money or services or a renewal through false pretenses, fraud or using a fraudulent written financial statement.

Fraud or Defalcation of a Fiduciary, Embezzlement or Larceny

This category of nondischargeable claims under 11 USC 523(a)(4) contains many potential surety related issues. There are several possibilities that could place a principal in the position of a fiduciary. Some states statutorily create a trust for payments received on a construction project.⁶ If you are dealing with a principal in a state that has such a statute, the principal may be a fiduciary relating to those funds, but not necessarily.⁷ During the financing of a principal or in some of the creative arrangements when both a surety and a contractor are involved on a project, such as when the surety has arranged for the "defaulted" principal to complete construction of a project with the surety's assistance, there exists the possibility that the contractor/principal may have fiduciary duties to the surety. A place where it could arise

⁶ See, e.g. Tex. Prop. Code § 162, "Texas Construction Trust Fund Act"

⁷ Consolidated Electrical Distributors, Inc. v. Cook, No Civ. A H-05-0879, 2006 WL 470586, at *6 (S.D. Tex. 2006) [not designated for publication] ("the Texas Construction Trust Fund statute permits a finding of nondischargeability on certain findings . . ."In re Emmert, 11 B.R. 341 (Bkrtcy. W.D. Mich 1981) (holding that Michigan Builders Trust Fund Act did not in itself create a fiduciary capacity).

would be if the surety has consented to give the principal access to a pool of funds to help complete a project, the surety may require the principal to acknowledge in writing that there is a fiduciary relationship and the attendant fiduciary duties as a condition precedent to the surety effectively going into business with the principal or giving the principal access to contract balances. In the case of a probate bond surety, its principal owes fiduciary duties to the estate that it is helping to administer.

Under Texas law, fraud requires proof of six elements: (1) a material representation, (2) that was false, (3) that the speaker knew was false or was made recklessly without knowledge of its truth or falsity, (4) with the intent to have the other party rely, (5) actual reliance by the other party, and (6) damages. *T.O. Stanley Boot Co. v. Bank of El Paso*, 847 S.W.2d 218, 222 (Tex.1992) (citing *Stone v. Lawyers Title Ins. Corp.*, 554 S.W.2d 183, 185 (Tex.1977)); see also *Southwestern Packing Co. v. Cincinnati Butchers' Supply Co.*, 139 F.2d 201, 203 (5th Cir.1943). Fraud and deceit are essentially synonymous. See Restatement (Second) of Torts § 525 (deceit and fraudulent misrepresentation listed as the same cause of action); *Meyers v. Moody*, 693 F.2d 1196, 1214 (5th Cir.1982) (the elements of common law fraud or deceit are identical under Texas law); see also *Southwestern Packing Corp., Inc. v. Cincinnati Butchers' Supply Co.*, 139 F.2d 201, 203 (5th Cir.1943). In re Presto 376 B.R. 554, 594 (Bkrcty.S.D.Tex.,2007). The timing of the fraudulent actions are important in using this objection. The fiduciary duty must have already existed at the time the fraud occurred. *Id.* Fraud that induces someone to place you in the position of a fiduciary does not qualify under this section, but may elsewhere.

Defalcation, on the other hand, does not require such a stringent showing. 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 (6th Ed.) at 417. Simply being unable to account for trust funds is sufficient to satisfy the definition of defalcation.

In the construction surety context, this type of objection to discharge is most likely going to arise in conjunction with the principals use of contract funds. From state to state it seems to vary whether funds received on a construction project render the requisite fiduciary relationship necessary to invoke this objection. In the event there are issues that raise the suspicion of missing contract funds, the surety’s bankruptcy counsel should consider this a possible avenue to investigate.

False Pretenses, a False Representation, or Actual Fraud

There are two other objections to discharge relating to falsehoods and fraud. One relates to non-financial issues and the other to an insider’s financial records. The key difference between the two, is that false representations about an insiders financial records must be in writing to qualify for this exception to nondischargeability. The law is all over the board on which categories certain items fall into. A few things that would clearly fit into the category that frequently, if not always, arise in a surety context is a company’s financial statements. As such, a surety should be careful when accepting “information” it plans on relying on that is different than what is in the financial statement. By way of example, a concurrent explanation that some of the liabilities on a financial report are misstated because a case has been resolved, a dispute on a project over change orders has been settled, etc. should either not be considered in the underwriting or financing decision making process or reduced to writing and signed by the principal.

Possible areas to examine for fraud, false pretenses, etc. would be at the various points that the surety has made decisions relating to how to proceed. It is at these times that the surety can show reliance and damages. One of the times when that would occur would be at underwriting. Places to look for the fraud would be in the financial statements of the principal. Examine the dates of the financial statements provided and when the underwriting decision occurred. In the event the underwriter was provided old financial statements and chose to rely on them, rather than insisting on obtaining more recent financial statements, the surety may lose the ability to show justifiable reliance. When reporting the principal falsely reports the status of encumbrances on collateral (i.e. "I own it free and clear."), if the surety does not perform a simple investigation, such as a U.C.C. search, it may be difficult to show justifiable reliance as well.

The surety has a chance of being defrauded in conjunction with a decision to finance the principal after a default, a series of defaults, or in order to avoid a default. In determining whether facts warrant an objection to discharge it may be necessary to analyze both bonded and unbonded projects the principal was performing. The surety should be careful to require every representation the principal makes that it intends to rely on to be in writing at the very least. It is unlikely that a surety will have time enough to perform a review it is completely comfortable with on one bonded project, much less several projects, some of which are unbonded.

The surety has another chance of being defrauded with respect to claims the principal alleges it has against others. We often see principals in trouble rightly or wrongly contend that one of the very claimants on the bond is actually the cause of at least part of the trouble that the principal finds itself. Carefully reviewing the information provided by a principal when deciding whether or not to pursue its "claims" against a claimant could reveal a potential objection to dischargeability. In the event the principal misrepresented that it had counterclaims against a claimant as an inducement for the surety to forebear on resolving the claim and the surety ends up incurring additional fees, interest and expenses as a result of the misrepresentations, perhaps some of the lost, costs and expenses may be nondischargeable. One hundred percent of just a small part of the loss may be as rewarding as a small percentage of the entire loss.

One last potential source of nondischargeability facts would be when an indemnitor raises a defense that it did not sign the General Agreement of Indemnity, rather its name was forged. A review of the underwriting file, may support a claim for nondischargeability against the other indemnitors to the extent the surety can show it was relying on a particular indemnitor to be bound by the General Agreement of Indemnity in order to induce the surety to extend surety credit. Fraud, false pretenses, etc. can arise from silence. Presumably a husband would know whether or not his wife signed the General Agreement of Indemnity or whether her signature was forged. The surety should first check with the underwriter and the local agent to investigate the circumstances relating to the signing of the General Agreement of Indemnity, if known.

General Considerations of the Surety in Deciding Whether to Contest Discharge

By the time a case reaches the bankruptcy court, the surety may have already gone through at least one legal proceeding to get to its principal or indemnitors, not to mention negotiations or litigation with at least one underlying claimant. Filing an objection to discharge

is a whole new legal proceeding in which the surety will have the burden of proof. The decision on whether to object or not should be based on a review of many factors. First, how much does the surety have at stake? Second, how much does the surety expect to receive in the normal course of distributing the assets in the bankruptcy proceeding? Third, what type of principal or indemnitor is the surety facing? Is it someone who put everything he had into the company to make it succeed, but what he had wasn't enough? Or is it someone who made sure to take his profits out of the project? Does the principal/indemnitor have a future capacity to repay the surety? Does the surety expect, but can not prove, that the bankrupt has hidden assets? Seeing your way through an exemption to discharge could potentially shake loose a recovery, even if it ends up being a partial recovery with a payment plan.

In determining whether to move forward, a claims adjuster should visit with the underwriters to investigate the facts and documentation relating to the initial decisions to extend surety credit to the principal and to get a feel for whether the principal has a meaningful chance to repay the surety at some point. Keep in mind though, that in order to obtain the exemption to discharge, you have proven the principal has committed an "error" greater than simply running out of money. You have more than likely proven that the debtor has been misleading, fraudulent or a criminal. This may mean a long fight to recover on a debt you worked hard to maintain in spite of the bankruptcy.

EXEMPTIONS

The last consideration to discuss in this paper are the exemptions that are provided under the Bankruptcy Code. Not all of the debtor's property gets turned over to the estate. Individuals have a certain entitlement to exempt property. Corporations do not. This means that an individual debtor will be left with a certain amount of assets that will not be subject to the reach of its creditors. 11 USC § 522 provides for the exemptions. It is far too involved to discuss in its entirety in this paper. However, when considering whether to pursue the nondischargeability of a debtor, with the ultimate goal that the surety will realize something for its efforts, the exempt property retained by the debtor must be considered, both as a potential source for the debtor to voluntarily use to satisfy the nondischarged debt and/or the amount of assets that will be out of reach of the surety in its potential recovery.

Conclusion

In the coming years, when the loss cycle climbs and peaks, it may be necessary for sureties to become more aggressive in bankruptcy proceedings if they hope to recover for any of their losses. With careful documentation and some internal discussions between claims and underwriting, it may be possible to smoke out a reason to object to a debtor's dischargeability. Of course there are many factors that will need to be weighed in determining whether to fight on in an adversary proceeding or just take your share of the estate distribution, if there is any. As was discussed in the opening section, the law in the various jurisdictions is not entirely uniform and the surety will need to consult with bankruptcy counsel familiar with the law of the venue of the bankruptcy proceeding to try to determine where the surety stands. Even then, whether or not there was reasonable reliance, justifiable reliance or intent is as much of a fact intensive inquiry as you can get. Given the right set of facts and the right debtor, it may all be worthwhile.