

Recent Case Law: Contesting Discharge for Trust Fund Violations

By John V. Burch April 3, 2019

Indemnity Agreements typically contain a trust provision stating that contract funds received are trust funds. A recent bankruptcy case out of Florida analyzed whether that language was enough to create a trust, and if so, whether a violation of that trust might bar discharge of an individual indemnitor's debts in bankruptcy.

The personal indemnitor, in *In re: Brandt*, 594 B.R. 829 (S.D. Fla. 2019), used project funds to pay legitimate costs as well as personal expenses.

The Bankruptcy Code excludes discharge of a debt incurred via "fraud or defalcation while acting in a fiduciary capacity." 11 U.S.C. § 523(a)(4). Fiduciary responsibilities do not arise unless there is an express or technical trust in existence prior to the act of fraud or defalcation.

The court first held that the trust created by the indemnity agreement was a technical trust (that is a trust with defined obligations). The fundamental holding was that an Indemnity Agreement will establish an enforceable trust where the language creates the trust, identifies a trust corpus, and shows an intent by the parties to create a fiduciary relationship.

Of course, establishing that there is a trust creating a fiduciary relationship is simply the first step in barring discharge. There must be a defalcation.

The Supreme Court has held that a defalcation under 11 U.S.C. § 523(a)(4) requires an intentional wrong where the conduct at issue did not involve bad faith, moral turpitude, or other immoral conduct. *Bullock v. BankChampaign, N.A.*, 569 U.S. 267, 273, 133 S. Ct. 1754, 185 L. Ed. 2d 922 (2013).

Will the personal indemnitor's use of project funds for personal expenses amount to defalcation so that discharge would be barred? How does *Bullock* apply to the facts of this case?

Bullock's holding that there must be a "defalcation" to block discharge can raise a high hurdle. Prior to that decision, the standard for defalcation was relatively low. Not so anymore. *Bullock* relied heavily on criminal law and required an intentional wrong, including not only conduct that the fiduciary knows is improper, but also actions that are reckless, to the point that it is a gross deviation from the standard of conduct of an ordinary person.

In *In re: Cupit*, 514 B.R. 42 (Bankr. D. Colo. 2014), the court applied all of these principles when it granted a partial discharge. That case involved an unpaid supplier who sought to bar discharging debts of the contractor because of a violation of the statutory construction trust fund. The court denied discharge for claims of larceny and embezzlement because, applying criminal law rules on intent and the holding in

Bullock, it thought the contractor had to be aware of the statutory trust fund and he was not. So, it held there was no intent to violate the trust fund statute and no discharge on that ground.

In a rather contradictory holding, the court then applied Colorado case law and found there was a “knowing use” of contract funds that was a violation of the statute when the debtor paid oldest bills first, rather than those supplying the material which generated the payment in question.

In *Cincinnati Ins. Co. v. Chidester*, 2013 WL 4539103 (W.D. Va. 2013), the conservator for an estate failed to account for funds and, when summoned to appear and show cause why he was not liable and that the bond should not be forfeited, he failed to appear. That court issued an order forfeiting a \$200,000 bond, and the surety obtained a default judgment.

The bankruptcy court denied the surety summary judgment when it sought to bar discharge. On appeal, the district court held that, while there was no dispute that the guardian was a fiduciary, summary judgment for the surety was not appropriate because the surety had to make a factual showing in bankruptcy court that the guardian consciously disregarded his duties and a substantial and unjustifiable risk of breaching his fiduciary obligations.

The *Brandt* court has not yet had an opportunity to answer these questions. Arising at the Motion-to-Dismiss stage, the court simply found that enough evidence of defalcation was alleged in the Complaint to avoid dismissal.

The “heightened standard” required for discharge by *Bullock* will certainly cause the court to delve into the facts surrounding exactly how the funds were managed or mismanaged. The *Bullock* decision unquestionably creates varying analyses by the courts and raises complicated issues.