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In This Issue

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Diversion of Progress Payments to Pay Expenses on Another Project Constitutes Breach of Fiduciary Duty Owed to Surety Arising From Express Trust Relationship Created by Indemnity Agreement: Principal's Debt to Surety Not Discharged in Bankruptcy

By Samuel J. Arena, Jr.

A number of bankruptcy courts have addressed the issue of whether an express trust pertaining to contract funds created by an indemnity agreement executed by an individual debtor in his individual capacity gives rise to a fiduciary duty to the surety. These courts have uniformly held that under such circumstances a trust may arise within the confines of an indemnity agreement.¹ Where the debtor or its principals violate the trust agreement by paying expenses for another job, and thereby breach the fiduciary duty, the underlying debt owed to the surety is non-dischargeable under the United States Bankruptcy Code. A recent opinion that applies this rationale and holds in favor of the surety on this issue is *International Fidelity Insurance Company v. David Patrick Herndon*, 277 P.R. 765 (Bankr. E.D. Ark. 2002) ("*In re Herndon*").

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The debtor in *In re Herndon*, David Herndon ("Debtor"), was president of IBECX L.L.C., a construction company that installed underground pipes and utilities. The Debtor was responsible for "office work" which included duties concerning the accounts payable and accounts receivable of IBECX. IBECX maintained two bank accounts, a general account and a payroll account. Receivables from construction contracts were all deposited into the general account. IBECX did not segregate funds received from the various projects which were underway at the same time, and all IBECX's bills were paid from the general account.²

In 2000, IBECX was awarded a contract to perform work on a water line relocation known as the Fairplay Road Project in Saline County, Arkansas. The contract price was \$123,984.00. As part of

the contract documents, the Debtor individually executed an indemnity agreement in favor of International Fidelity Insurance Company (“International”), which wrote a payment and performance bond for IBECX on the Fairplay Project. A term in the indemnity agreement entitled “Trust Fund” provided as follows:

[I]t is expressly understood and declared that all monies due and to become due under any contract or contracts covered by the Bonds are trust funds, whether in the possession of the Contractor or Indemnitors or otherwise, for the benefit of and for payment of all such obligations in connection with any such contract or contracts for which the Surety would be liable under any of said Bonds, which said trust also inures to the benefit of the Surety for any liability or loss it may have or sustain under any said Bonds, and this Agreement and declaration shall also constitute notice of such trust.

The indemnity agreement named IBECX as the Contractor, the Debtor as an Indemnitor, and International as the Surety.³

As part of the Fairplay Project, IBECX purchased water pipe on credit from Hughes Supply, Inc. for a price of \$50,000.00. The pipe was delivered to the job site in June 2000. In August, 2000, IBECX applied for and received a draw of \$55,131.61 on the contract from the owner. Approximately \$50,000.00 of the draw was for the pipe purchased from Hughes. Shortly thereafter, work on the project was halted because the owner had failed to acquire the necessary right-of-ways. A mile of pipe had been laid when the project ceased.⁴

IBECX did not use the

\$50,000.00 payment to pay Hughes for the pipe supplied for the Fairplay Project. The money was deposited by the Debtor in IBECX’s general account, and IBECX ultimately used the money in connection with another project. Hughes made a claim against International’s bond and was paid by International. On January 10, 2001, the Debtor filed a voluntary petition for relief under the provisions of Chapter 13 of the United States Bankruptcy Code. Thereafter, the Chapter 13 proceeding was converted to a Chapter 7. On July 16, 2001, International filed a complaint to determine the dischargeability of the debt to International in the amount of \$50,091.61 on the grounds that the debt owed to International was the result of a defalcation by a fiduciary in violation of 11 U.S.C. § 523(a)(4). A trial on the merits was held wherein it appears that the primary issue was whether the indemnity agreement signed by the Debtor in his individual capacity created a fiduciary duty on the part of the Debtor in favor of the surety, the breach of which triggered the non-dischargeability rules set forth in 11 U.S.C. § 523(a)(4).

Holding for the surety on this issue, the bankruptcy court began by reviewing the relevant provisions of the Bankruptcy Code. The Code excepts from discharge “debts which are for . . . defalcation while acting in a fiduciary capacity . . .” 11 U.S.C. § 523(a)(4) (1994). Defalcation under this section of the Code is the misappropriation of funds held by a fiduciary and includes the innocent default of a fiduciary who fails to account fully for money received. Code reference to “fiduciary capacity” applies in the strict and narrow sense as arising either from duties reposed in a trustee through an express trust or through a statute or other state rule creating fiduciary status cognizable in bankruptcy. “To except from discharge a debt for defalcation, the complainant must prove that either an express or statutorily created trust exists, that the debtor owed a fiduciary duty arising from that trust, and that the debtor breached that duty through defalcation.”⁵ In discussing the bankruptcy courts’ treatment of these provisions,

the court noted that the although “Federal courts construing this code section generally agree that the requisite fiduciary capacity must arise from an express or technical trust created prior to the defalcation and without reference to it,” “[m]erely labeling a relationship as a insufficient to create fiduciary capacity under the bankruptcy code.” *Id.* Citing the Eighth Circuit, the court stated that with reference to Section 523(a)(4), “[i]t is the substance of the transaction, rather than the labels assigned by the parties, which determines whether there is a fiduciary relationship.”⁶

Citing to and agreeing with the reasoning of the cases cited above, the court in *In re Herndon* easily found that the elements of the defalcation rule had been met. *Id.* Judge Mixon concluded that “IBECX and the Debtor as a fiduciary agreed that the trust money would be used to pay expenses incurred on the Fairplay Road Project, and this agreement was violated when the money was diverted to pay expenses for another job. That failure to apply funds entrusted to a fiduciary in accordance with the terms of a trust is a defalcation, whether intentional or not.”⁷ Since the Debtor violated his express trust by paying the monies to debts incurred on another project, he was found to have committed a defalcation by a fiduciary within the meaning of 11 U.S.C. § 523(a)(4). Accordingly, the court determined the debt to the surety to be non-dischargeable.

Endnote

1. See, e.g., *Wright v. Gulf Ins. Co.*, 266 B.R. 848, 852 (Bankr. E.D. Ark. 2001) (determining debt to surety was not dischargeable for defalcation based on express trust in indemnity agreement); *Cumberland Sur. Ins. Co. v. Smith*, 238 B.R. 664, 672 (Bankr. W.D. Ky. 1999) (same); *Gillespi v. Jenkins*, 100 B.R. 74, 76-77 (Bankr. N.D. Fla. 1990) (same). See also *Federal Ins. Co. v. Fifth Third Bank*, 867 F.2d 330 (6th Cir. 1989) (holding, in a non-bankruptcy context, that state’s contract with general contractor created express trust on progress payments for job creditors).
2. *Id.* at 767.
3. *Id.*
4. *Id.* at 768.
5. *Id.* at 768.
6. *Id.* at 769 citing *Barclay’s Am./Bus. Credit, Inc. v. Long*, 774 F.2d 875, 878 (8th Cir. 1985).
7. *Id.* at 769 citing *Tudor Oaks Ltd. P’ship v. Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997)