



BENEFIT NEWS BRIEFS

Dischargeability of Employer Contributions and the Bankruptcy Code

Last issue we looked at a case from the Ninth Circuit that addressed the dischargeability of withdrawal liability under the Bankruptcy Code. This issue we will look at a case from the Massachusetts Bankruptcy Court in the case of *Fahey v. Raso, Cause Number: 11-10505 (Bankr. D. Mass., June 11, 2013)*. The case is available by "[clicking here](#)."

The Parties

In this case, the Debtor who filed for bankruptcy, Raso, was the president, treasurer, and sole shareholder of Zani Tile Co., Inc. ("Zani") until the business ceased operating in August 2010.

Fahey, the plaintiff, is trustee and treasurer for the Massachusetts Bricklayers and Masons Health and Welfare Fund, Pension Fund, and Annuity Fund (collectively, the "Funds") and also the president and secretary-treasurer of the Bricklayers and Allied Craftsmen Local Union No. 3 of Massachusetts, Maine and New Hampshire (the "Union").

What Happened?

As Zani's "sole decision maker," the Debtor was in charge of day-to-day operations and was responsible for the company's bookkeeping, including payment of Zani's bills. In 1977, Zani entered into a collective bargaining agreement (the "CBA") with the Union, under which Zani agreed to be bound by the terms of the Trust Agreements.

Zani agreed to pay contributions (the "Contributions") to the Funds for each hour worked by employees covered by the CBA. The Trust Agreements provided that:

"all [C]ontributions shall be considered and defined as plan assets including [C]ontributions that are properly due and owing but not yet paid to the Fund by Contributing Employers."

The Contributions were amounts paid on Zani's behalf from its operating funds. The Debtor was responsible for overseeing payment of the Contributions to the Funds, and each month Zani submitted remittance reports to the Funds indicating the amount of Contributions due for each employee.

Zani was timely in its payment of Contributions until November 2008, at which time payments became consistently late and eventually stopped. During that time, however, Zani was paying at least some of its other corporate obligations.

The Fund sued Zani and Raso to collect the unpaid contributions and union dues which Zani collected but did not transfer to the Union. After obtaining judgments against Zani and Raso, they filed bankruptcy. Eventually, the bankruptcy case came down to whether the debt for the unpaid contributions was or was not dischargeable.

The Issue Before the Court

After some litigation the matter before the Court was whether the unpaid employer contributions were prevented from being discharged because the Debtor's actions constituted defalcation.

The Plaintiff argues that the Debtor's failure to pay Contributions was a "*defalcation*" within the meaning of 11 U.S.C. Section 523(a)(4) because as a fiduciary of the Funds, the Debtor owed a duty of loyalty that required him to act in the Funds' best interest and not engage in "*self-dealing and self-preservation.*" The Debtor violated the duty of loyalty by "*prioritiz[ing] the payment of corporate expenses in order to benefit himself rather than pay the employee benefit contributions due and owing.*" The Plaintiff argues that a defalcation may be presumed from this breach.

The Debtor contends that his failure to pay the Contributions is a mere "*breach of contract for which [the Debtor] cannot be found to have been guilty of fraud or defalcation.*"

What Is A Defalcation?

Section 523(a)(4) of the Bankruptcy Code exempts from discharge debts for "*defalcation while acting in a fiduciary capacity...*" This exception requires a creditor to show, by a preponderance of the evidence, that: (1) an express or technical trust existed "*prior to the act creating the debt and without reference to the act,*" (2) the debtor acted in a fiduciary capacity with respect to the trust, and (3) the debt arises from a defalcation. Only the third issue was before the Court.

No doubt you are asking, "*What is a defalcation?*" Unfortunately, the court's observation was:

"The exact meaning of "*defalcation*" as it is used in 11 U.S.C. Section 523(a)(4) has long confounded the courts."

Did the Debtor Commit a Defalcation?

However, the Court followed a precedential trail to conclude the Debtor's actions in this instance constituted a "defalcation":

- pursuant to statute, an ERISA fiduciary "*shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries...*"
- case law supports the proposition that where a defendant "*assum[es] conflicting roles as a fiduciary and as an officer of a struggling corporation, defendant prevented himself from fulfilling his duty to act with complete loyalty to Plan participants.*" (emphasis added)
- the First Circuit (which includes MA) has previously held in that such a breach of the *duty of loyalty* constitutes a "defalcation." See *In re Baylis*, 313 F.3d 9, 20-21 (1st Cir. 2002):

Defalcation may be presumed from breach of the duty of loyalty, the duty not to act in the fiduciary's own interest when that interest comes or may come into conflict with the beneficiaries' interest:

A trustee occupies a position in which the courts have fixed a very high and very strict standard for his conduct whenever his personal interest comes or may come into conflict with his duty to the beneficiaries. As long as he is not acting in his own interest the standard fixed for his behavior is only that of a reasonable degree of care, skill, and caution. But when the trustee acts in his own interest in connection with the performance of his duties as trustee, the standard of behavior becomes more rigorous. In such a case his interest must yield to that of the beneficiaries.

2A [A. Scott, *The Law of Trusts*] § 170.25 [(W.F. Fratcher ed., 4th ed. 2001)].

- as with the other fault-based exceptions to the Bankruptcy Code, fault may be presumed from the circumstances - here a violation of the duty of loyalty.

The Court's Decision

The Bankruptcy Court noted that under the Trust Agreements, unpaid contributions that were due and owing were assets of the Funds. (This conclusion is consistent with most courts finding unpaid employer contributions are "plan assets" only if the Trust document defines them as such). Thus, *Raso* was an ERISA fiduciary with respect to such monies.

The Court acknowledged that the Debtor does not dispute that he was aware of his obligations to the Funds, but nonetheless failed to remit the assets. Instead of paying the unpaid contributions, the Debtor prioritized the payment of corporate expenses that were beneficial to him over his obligations to the Funds. *Raso* clearly violated the duty of loyalty with regard to the monies.

In so finding, the Court held that Raso committed a defalcation under the Bankruptcy Code, making the unpaid contribution debt non-dischargeable.

Conclusion

One lesson to be learned from this case is for Funds to identify employer contributions "due and owing" as plan assets in order to attempt to secure these unpaid obligations from the possibility of being discharged in a bankruptcy proceeding.

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