DON'T ROB PETER TO PAY PAUL

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When businesses experience financial difficulties, it is very common for them to "rob Peter to pay Paul." Occasionally, this takes the form of using taxes that have been withheld from employees' paychecks to pay expenses instead of remitting those funds to the IRS. Of course, it is well known that even though such obligations are corporate, individuals within the corporation determined to be "responsible persons" will be personally liable for such taxes. Moreover, such liability will be non-dischargeable under §523(a)(1)(A) of the Bankruptcy Code should that individual file for bankruptcy.

The recent 8th Circuit Bankruptcy Appellate Panel decision in the case of U.S. Dept. of Labor v. Harris 2017 WL65392 (Bankr. 8th Cir. 2017) is illustrative of another situation in which a corporate executive incurred a non-dischargeable debt by deciding which bills would be paid from available corporate funds. In Harris, the chapter 7 debtor (the "Debtor") had been the President and CEO of a manufacturing company in which he owned a small amount of stock (not a controlling interest) The company sponsored and was the plan administrator for an employee health plan (Plan). The Plan contracted with an insurance company to provide healthcare benefits to the employees. The employees paid $100% of the premium which were withheld from their paychecks via payroll deductions. The withheld premiums were to be sent by the company to the insurance company on a monthly basis. Unfortunately (and foolishly) the company did not create a separate account for these funds. They went into the company's general operating account.

During the year 2008, the company was late making the payments ten times (including two bounced checks), but was able to obtain extensions of time for the payments. On January 27, the company sent a check to the insurance company in the amount of $22,593.02 for the January premiums. The check bounced. In February, the company was notified of the bounced check and advised that coverage would be terminated if the premiums were not paid in full. In March the Debtor asked for an extension of time to bring January and February payments (around $55,000) current, but that request was denied. At that time, the company had in excess of $70,000 in its operating account. Instead of paying the delinquent insurance premiums for its employees the company paid other expenses. Also, at the Debtor's direction, it paid off for more than $25,000 of the Debtor's personal obligations. The insurance was terminated leaving forty two employees without coverage. The Debtor resigned shortly thereafter and the company was later liquidated. During the period leading up to the termination of coverage, the Debtor as CEO had the ultimate authority as to which bills to pay and he was personally involved in the decision not to remit the withheld employee premiums to the insurance company.

In 2012, the Secretary of the Department of Labor ("DOL") sued the Debtor alleging that by failing to remit the $55,040.61 in withheld premiums to the insurance company, he breached his fiduciary duties to the company's employees and their health plan in violation of ERISA. Following a three day trial, the District Court entered judgment in favor of DOL in the amount of $67,839.60, concluding that the Debtor violated his fiduciary duty under ERISA by diverting the employee contributions to pay for corporate expenses. The Debtor soon thereafter filed a Chapter 7 bankruptcy case.

The DOL filed a claim in the Debtor's case and filed a complaint under § 523(a)(4) of the Bankruptcy Code seeking to have the $67,839.60 judgment declared non-dischargeable. Section 523 (a)(4) makes non-dischargeable any debt "for fraud or defalcation while acting in a fiduciary capacity". The bankruptcy court granted summary judgment in DOL's favor and the Debtor appealed.

In affirming the Bankruptcy Court's judgment of non-dischargeability, the Appellate Panel analyzed three questions: (1) was there a trust res? (2) did the Debtor (as opposed to the corporation) have fiduciary responsibilities with respect to that trust?; and (3) did the Debtor commit defalcation in directing the company to pay expenses other than the past due premiums.

As to the first question, the Appellate Panel held that on the date the employees' wages were withheld they became "plan assets" with respect to the employee health plan. Since those funds actually belonged to the employees, they constituted the trust res. The Appellate Panel contrasted this with cases in which a company has a contractual duty to pay for employee benefits (not from employee funds), thus creating fiduciary duties under ERISA. However, those duties are not sufficient to impose liability under §523(a)(4)?

As to the Debtor's individual liability, the Appellate Panel found as the Debtor had conceded, that he, as the CEO, had the ultimate authority as to which bills to pay. Thus, he had fiduciary responsibilities with respect to the withheld funds.

Defalcation is the misappropriation of trust funds and the failure to properly account for such funds. When the Debtor, with knowledge that the company had sufficient funds to pay for the employee health plan premium, directed that other corporate expenses and his own personal expenses be paid instead, he committed a defalcation as defined in §523(a)(4). Thus, the debt was non-dischargeable in his personal bankruptcy.

Looking at this situation in hindsight, it is obvious that what this CEO and his company did was wrong. It is unlikely, however, that he planned to do things this way. As the company's finances (and obviously his own) became tight, he scrambled to keep afloat. Many businesses routinely withhold funds from employee paycheck for a variety of purposes of course; FUTA and FICA tax withholdings are required to go into a separate account. However, other withholdings such as health insurance premiums, or court ordered support, may be placed in the business' operating account and then paid. If such is the case, it is vital that procedures are established to insure the employee funds are properly applied prior to any other payments. Otherwise, the responsible officers may face a non-dischargeable liability.

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