

**August, 2004
No. 1**

Fidelity & Surety

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Bankruptcy Court Sides with Surety and Denies Discharge to Owner of Corporate Principal

By Roger P. Sauer and Philip Allogramento

The setting is sufficiently similar to make it mundane. Letters flow from the obligee threatening default. In response, the principal confesses to financial collapse and a consequent inability to complete its work. The surety steps up to the plate and spends a fortune to get the job done and pay off the creditors. Then, with nowhere else to turn, it looks to its individual indemnitors for at least some recompense under the GIA, but the latter, alas, promptly file for personal bankruptcy. All is lost.

In a case¹ recently brought to our attention by Edward G. Gallagher, Esq., of the Surety Association of America, the moral of the story has to be: it ain't necessarily so. For those of us who practice in the surety field, the case is replete with virtues, even apart from the most obvious one, that the bonding company prevailed in all material respects. First, we believe that the opinion deals with facts that are commonplace in the industry, although perhaps not always as vigorously pursued as was true with this particular surety. Second, and perhaps most important of all, the opinion seems to manifest a pervasive comprehension of how surety underwriting in fact works. Kudos to Judge Stocks. Finally, for those of us with the candor to acknowledge that a surety practice makes us bankruptcy "experts" by, at best, a process of osmosis, the opinion provides a literal blueprint for gathering the necessary proofs, should they exist.

The IADC

The IADC dedicates itself to enhancing the development of skills, professionalism and camaraderie in the practice of law in order to serve and benefit the civil justice system, the legal profession, society and our members.

The Facts

Pretty straightforward. Summit Companies, LLC (Summit) was a general contractor. As of February 2000, Thomas Adams (Adams), the debtor, was managing member, officer and employee of Summit². At that time, the contractor was seeking performance and payment bonds in connection with a contract for work at a North Carolina state run school for the arts. Through an agency known as "Bonds Only, Inc.", Adams submitted various financial information on Summit to the plaintiff surety through its writing agent, Cumberland.

The process seems to have resulted in solicitation of the customary disclosures on the construction company's finances. This was done through a "Contractors Surety Application Questionnaire" furnished by Bonds Only. And although the latter played some role in putting the information together, it appears that in all material respects Adams controlled the process and furnished the data. There were questions about work in progress as well as jobs already completed. A biographical sketch on Adams was furnished.

Admittedly, Adams played pretty fast and loose with the truth. The application materials asked if any liens had been filed against the company. An inquiry was also made about pending litigation and/or arbitration. All such inquiries were answered in the negative, when in fact at least a dozen liens or suits were pending. One of the claims was for over \$100,000. There were other undisclosed problems, too. The September 30, 1999 financial statement that had been submitted somehow neglected to mention approximately \$800,000 worth of corporate liabilities, with a resulting overstatement of working capital by roughly half that amount. The reality was indeed grim.

It should probably come as no shock that Summit tanked. If anything, it is surprising that

it appeared to have continued in operation for roughly two years after the bonds issued. However, in the end, the surety wound up going nearly \$1.6 million into the hole.

The Bankruptcy Code

11 USCA section 523 is the provision of the Bankruptcy Code under which a complaining party may object to the discharge of a specific debt³. Subsection (2) of this portion of the Statute generally deals with fraudulently contracted debts, an in turn, provision (B) deals more particularly with activity based upon a false writing. Ultimately, there are six components to the claim. First, the debt must involve a claim for "money, property, services, or an extension, renewal, or refinancing of credit". Second, what was obtained must have been secured through use of a "statement in writing". Third, the writing must be "materially false". Fourth, the writing must be "respecting the debtor's or an insider's financial condition". Fifth, the creditor must have reasonably relied upon the false writing. Finally, the debtor must have had an intent to deceive.

Under the circumstances, it is understandable that some of the criteria, such as, for example, the intent to deceive and the existence of a writing required little, to no, discussion at all. But in all cases, the analysis was probing.

The Analysis

The discussion of the pre-ambulatory language was particularly interesting. For while the Court noted that the archetypal situation involved a loan from a lending institution, it simultaneously recognized that many other types of fact patterns would qualify, specifically citing a fraudulently induced home sale⁴ and a title policy that had been procured by fraud⁵. In the end, it was of the opinion that section 523 (a) (2) relief could be available to a creditor as a result of being induced into "virtually any type of business

transaction by fraud".⁶

Another interesting twist came from the fact that the documentation in question related to the financial condition of the construction company that was bonded, and not the debtor, himself. However, the Court found this to be a distinction without a difference. For under section 101 (31) of the Bankruptcy Code, if the debtor is an individual, an "insider"⁷ includes a corporation of which the debtor is a director, officer or person control.

Also noteworthy was the discussion of the materiality criterion. Material misrepresentations were described as "substantial inaccuracies of the type which would generally affect the lender's decision." or ones that "portray a substantially untruthful picture of a financial condition by misrepresenting information of the type which normally would affect the decision to grant credit". In this portion of the opinion, surety practitioners can take particular comfort. This was one judge who clearly listened to the bonding company's expert and understood what he had to say. The Court had no trouble whatsoever accepting the fact that liens and suits against the contractor make a difference in the underwriting decision, as does a gross misstatement of working capital.

Finding reliance was easy, but dealing with the issue of "reasonable" reliance took a bit more doing. Reasonableness is something found on a case-by-case basis, judged in light of the totality of the circumstances. The standard is an objective one.¹ Apparently, the debtor took the position that the fraud could have been discovered through greater investigatory efforts on the part of the surety. Probably true, at least in theory. However, the Court was unimpressed. It found that there were no "red flags" on the face of things. Something more than a "minimal investigation" would have been necessary to unearth the truth, in all likelihood and "extensive examination of public records in North Carolina". The surety was not held to such a

burden.

Of course, one has to do a little reading between the lines as well. There seems to be little doubt that this Court found this particular indemnitor to be a bad actor. Note was specifically taken of the amount of time that Adams had been in the construction business, too. Because nondischargeability cases are indeed so fact sensitive, any case that follows will undoubtedly have its own idiosyncratic twists and turns as well. On the other hand, to return to the point of beginning, *Adams* nonetheless provides a worthy roadmap for a surety questioning whether it ought to object to a petitioned discharge, and if so, just what it might take to succeed.

Conclusion

Contracts go bad, and contractors can have reversals of fortune, for many reasons, most of which, at least hopefully, have nothing to do with fraud. However, as the house of cards begins to crumble and the surety claims person is considering all the options, it probably never hurts to peruse the underwriting file, maybe do a little more digging and see how things stack up against what happened in this case.

Endnotes

1. *In re Thomas W. Adams and Suzanne H. Adams, Debtors*, 2000 WL 1656533 (Bankr. MDNC). The opinion does not make clear whether Adams or Adams and his wife were the sole owners of the corporate principal.
2. This provision is to be distinguished from 11 USCA section 727, under which the discharge of the debtor, him/herself may be challenged.
3. *In re Rubin*, 875 F.2d 755 (9th Cir. 1989).
4. *In re Dallam*, 850 F.2d 446 (8th Cir. 1988).
5. Other cases have recognized the ability of surety companies to seek nondischargeability of a debt under 11 U.S.C.A. § 523(a)(2)(B). See *In Re Jenkins*, 110 BR 74 (Bankr. M.D. Fl. 1990)(holding that general indemnity agreement between debtor and surety created fiduciary relationship, such that debtor's payment of inordinate salary to himself rather than paying materialmen and suppliers gave rise to nondischargeable debt to surety); *In re Siriani*, 967

F.2d 302 (9th Cir. 1992)(Creditor, a surety of the debtor, unsuccessfully filed nondischargeability complaint on ground that it had relied on fraudulent financial statements in deciding to renew bond); *In re Baxter*, 294 BR 800 (Bankr. M.D. Ga 2003)(Surety on construction projects unsuccessfully brought adversary proceeding to

- except debt from discharge under § 523(a)(2)(B).
6. Remember that provision (a) (2) (B) (ii) also encompasses information on an "insider's" financial condition. See generally 4 Collier on Bankruptcy, section 523.08.
 7. *In re Brevard*, 200 BR 836 (Bankr. EDVa.1996).