ERNSTROM & DRESTE LLP

FIDELITY & SURETY

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Supreme Court Defines Defalcation; Debtors Rejoice

THOMAS K. O'GARA

The United States Supreme Court recently defined the term defalcation making it more difficult for sureties, or any other creditors, to have their debts declared to be non-dischargeable when a debtor files for bankruptcy. The new standard, as defined by the Court, contains a culpable state of mind requirement involving knowledge or gross recklessness in respect to the improper nature of the fiduciary's behavior. The Court's unanimous decision resolves a longstanding split among the lower courts over the proper interpretation of this phrase with respect to the discharge of a debt in bankruptcy.

Generally, when a debtor files for bankruptcy, all of the debtor's debts are forgiven or discharged. Under Bankruptcy Code § 523, various statutory exemptions apply to this general rule, the most common to sureties, section 523 (a)(4), does not discharge debts arising from "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." In the past, sureties have used this provision to have certain debts

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Right Or Obligation: Must A Surety Pursue Indemnitors' Affirmative Claim Against The Obligee?

NELL M. HURLEY

Although the surety had the right to seek recovery from an obligee based upon its principal's affirmative claims, a recent federal court ruling determined that the surety was not obligated to pursue those claims. In *International Fidelity Ins. Co. v. Aulson Co., Inc.*, 2012 WL 6021130 (S.D.N.Y. Dec. 4, 2012), the court rejected the indemnitors' arguments that the surety breached its duty of good faith and fair dealing and its duty to mitigate damages by not making efforts to obtain delay damages the principal claimed it was entitled to under the bonded contract. In granting summary judgment to the surety, the court looked to the language of the forbearance agreement and promissory note, rather than to the collateral security agreement and underlying indemnity agreements, to determine the surety's obligation to pursue the indemnitors' claims.

The contracts at issue involved the repair and refurbishment of a number of bridges in New York City. The Aulson Company, Inc. ("Aulson"), principal, obtained initial bonding from two surety companies, International Fidelity Insurance Co. and United States Fire Insurance Company (collectively the "Surety"). The obligee was the general contractor Koch Skanska Inc. ("Skanska"). Aulson and others executed indemnity agreements in 2002 and again in 2005.

In March 2007, Aulson informed the Surety that it was unable to perform its obligations under some of the bonded contracts, and Skanska called on the Surety to fulfill these obligations. As a part of the Surety's obligations, it entered into a takeover agreement with Skanska and then hired Aulson to complete the work Aulson was originally contracted to perform. Aulson's work was repeatedly impeded by circumstances outside of its control, and Aulson asserted that it had a delay claim against Skanska for $4M.

In fulfilling its obligations under the bonds, the Surety incurred losses and expenses of $11.9M. The Surety demanded security from the indemnitors, which was not provided. Instead, in August 2007, the Surety entered into a Forbearance Agreement with the indemnitors that liquidated and reduced the indemnitors' indebtedness to $6M and delayed collection for two years. The Forbearance Agreement also included a provision waiving all of the indemnitors' claims against the Surety because of the payment and settlement of claims under the surety bonds. The indemnitors concurrently executed promissory notes, which included a default and acceleration provision. At the same time, all parties executed a collateral security agreement whereby the indemnitors assigned to the Surety, among other things, their rights to all affirmative claims against Skanska.

Although a few payments were made by Aulson, by March 2011, Aulson was in default. The Surety demanded payment of approximately $7M due under the

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Does The Common-Interest Privilege Apply Between Surety And Principal?

MATTHEW D. BROWN

New York recognizes a common-interest privilege, which includes communications between an insurance company and its insured. There does not appear, however, to be any reported decisions dealing directly with whether the common-interest privilege applies to communications between a surety and its principal. But, the same rationale that acknowledges a common-interest privilege between an insurance carrier-insured relationship should apply equally to a surety-principal. While the common-interest privilege is not an absolute privilege, it may be helpful when the surety's attorney corresponds with the surety's principal to discuss certain bond claims.

For a communication to qualify as protected under the attorney-client privilege pursuant CPLR 4503(a), it must be primarily or predominantly of a legal character to obtain or render legal advice or services and intended to be confidential.

The attorney-client privilege is waived, however, when communications between counsel and client are voluntarily shared with third parties. An exception exists for communications made by or in the presence of one serving as an agent for either attorney or client since a client has a reasonable expectation that such communications will remain confidential. The presence of a third party will also not waive the attorney-client privilege if the common-interest privilege exists. The common-interest privilege applies to communication between counsel and parties regarding legal advice in pending or reasonably anticipated litigation in which the joint consulting parties have a common legal interest.

Under New York law, the common-interest privilege protects the confidentiality of communications among parties pertaining to their joint efforts to achieve a common legal goal. This includes communications made in the course of an ongoing common enterprise that are intended to further the efforts of the enterprise. The common-interest privilege even applies to communications among parties regarding their joint efforts regarding a limited common purpose, even if they potentially are adversaries. For example, courts have upheld the common-interest privilege between a plaintiff and defendant who have a joint strategy against another party.

Thus, where a surety's counsel discusses strategy and other legal issues with the surety's principal with the common goal of defending a lawsuit brought by a subcontractor to the surety's principal, the common-interest privilege should apply and protect that communication. E&D

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declared to be not dischargeable when a debtor files for bankruptcy. The Supreme Court has just made that task more difficult.

The debtor in *Bullock v. Bankchampaign, N.A.*, 2013 WL 1942393 (May 13, 2013) was appointed as trustee of a trust set up by his father. The only asset in the trust was the father's life-insurance policy, which permitted the debtor to borrow against the value of the policy. The debtor borrowed against the policy on three occasions and repaid the funds along with a 6% interest charged by the life-insurance company.

The debtor's brothers, beneficiaries of the trust, sued the debtor in Illinois state court alleging that the debtor breached his fiduciary duty as trustee by making loans for his own benefit. The debtor's brothers admitted that the debtor did not have a malicious motive in borrowing the funds, but was nonetheless involved in self-dealing. The state court agreed and entered judgment against the debtor for the benefits he received from his breach and attorneys' fees. Soon thereafter, the debtor filed for bankruptcy.

The new trustee of the father's trust opposed the debtor's attempt to discharge the state-court judgment in bankruptcy, arguing that the debt was non-dischargeable defalcation while acting in a fiduciary capacity. The Supreme Court granted certiorari to define defalcation, as the term has not had a uniform definition and has been applied differently by the lower courts for over 150 years.

In heightening the standard for defalcation, the Supreme Court first examined the meaning of "fraud" under § 523(a)(4). The Bankruptcy Code's exception to a discharge based on fraud requires positive fraud, or fraud in fact, involving moral turpitude or international wrong, not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality. The Court held that "defalcation" should be defined in the same way.

Therefore, when acting as a fiduciary, the debtor must commit an intentional wrong for the debt to be not dischargeable in bankruptcy. Under this standard, the fiduciary must not only know that its actions are improper but must demonstrate a reckless conduct of the kind that criminal law often treats as the equivalent. Where actual knowledge of wrongdoing is lacking, conduct is considered as equivalent if, as set forth in the Model Penal Code, the fiduciary "consciously disregards," or is willfully blind to, "a substantial and justifiable risk" that his conduct will violate a fiduciary duty. This disregard must involve a gross deviation from the standard of conduct that a law-abiding person would observe in similar circumstances. The debtor in Bullock did not meet this heightened standard.

With this heighten standard, it will be more difficult for creditors to have their debts declared not dischargeable. Previously in New York, the most common way for a surety to avoid discharge of its judgment in bankruptcy was to establish a violation of article 3-A of the New York Lien Law for diversion of trust assets. It is unclear if the Supreme Court's ruling will have any impact on article 3-A debts, as violations of article 3-A are also punishable by criminal law, which seems to fit the heightened standard set forth in Bullock. E&D

terms of the Forbearance Agreement and the promissory notes, and the Surety brought suit against Aulson and all indemnitors ("Defendants"). The Defendants asserted affirmative defenses based upon what they claimed was the Surety's duty to pursue the Aulson delay claim against Skanska, and the Surety's failure to do so.

The Defendants argued that the Surety had breached both its duty of good faith and fair dealing and duty to mitigate its damages by failing to pursue Aulson's affirmative delay claim against Skanska. While acknowledging that every contract contains a covenant of good faith and fair dealing, the court found no violation of that duty in the case. The Forbearance Agreement contained no obligation regarding the Surety's pursuit of Aulson's affirmative claims against Skanska. In addition, the Surety did not deprive the Defendants of the benefits of any of their contracts because Defendants had already enjoyed the benefit of the lowered indebtedness and the two years of forbearance.

The court rejected the Defendants' attempt to rely on case law involving claims of sureties against principals for indemnification. In such cases, a surety has a duty to act in good faith in investigating and paying the claim for which it is seeking indemnification. Here, the Defendants did not contest the Surety's payment of third-party claims. Rather, they complained that the Surety chose not to pursue an affirmative claim that may have offset the Defendants' indebtedness to the Surety. But, the Defendants' indebtedness was defined by the terms of the Forbearance Agreement and promissory notes.

Defendants' reliance upon language in the collateral security agreement and Forbearance Agreement assigning to the Surety the rights to all affirmative claims is also unavailing, according to the court, since there is no language in either document that obligates the Surety to investigate and pursue those claims. The power and right to sue on a principal's affirmative claims does not impose an obligation and responsibility to do so, it said. Instead, if the Surety chooses to settle such affirmative claims, it must do so in good faith.

The Defendants' effort to fashion the Surety's decision not to pursue the affirmative claim as a failure to mitigate its damages also failed because of the liquidation of damages under the Forbearance Agreement. The acceleration clause and provisions of the Forbearance Agreement setting the amount due to the Surety were enforceable liquidated damages clauses, relieving the Surety of any duty to mitigate damages.

Of course, the Surety's success in this case should not be broadly interpreted to mean that the surety has no obligation to investigate and pursue the claims its principal may have against a third party. Indeed, one case supporting that obligation, *Cincinnati Inc. Co. v. Savarino Const. Corp.*, 2011 WL 1068022 (S.D. Ohio 2011), is cited by the court. But where, as here, the indemnitors waived their claims under the indemnity agreement against the surety and, most significantly, a new agreement addressing the indemnitor's debt has been reached between the parties, the right to pursue the principal's affirmative claim does not translate into an obligation to pursue it as an off-set to the principal's debt to the surety. E&D

Direct Means Direct In Commercial-Crime Policy

NELL M. HURLEY

A New York State court recently granted summary judgment in favor of the provider of a commercial-crime policy, declaring that there was no duty to defend or indemnify a policyholder seeking coverage from its employee's theft from third parties. Ernstrom & Dreste represented the provider in the unpublished decision in which the court agreed that such losses were not "direct" and, therefore, not covered by the policy.

In the case, the employer provided counseling services to homeowners facing foreclosure. One of its employees induced a number of clients to give her money, allegedly in exchange for her intercession with their lenders, in contravention of her job description and company policy prohibiting accepting money from clients. The employee did not turn the money over to the employer or deposit it into any company account, but kept the money for herself. Eventually the theft was discovered, and the employee was prosecuted criminally and convicted. The homeowners who lost money to the dishonest employee brought an action against the employer to recover the sums lost. The employer, in turn, brought a declaratory judgment action against the commercial-crime policy provider ("Insurer") seeking coverage and a defense.

The Insurer argued that its commercial-crime policy provided coverage only for losses *directly* sustained by the insured, in this case, the employer. Numerous policy provisions were relied upon to demonstrate that the policy was one of indemnity, not liability. As such, the policy did not apply in situations where third parties are defrauded, and the insured itself sustains no loss. Because the employer had no pre-existing responsibility for the stolen property and was never itself deprived of it, the theft was not covered. In addition, courts regularly interpret this policy language, requiring that the loss be direct, as excluding claims where fraud was perpetrated against third parties. Such vicarious liability is deemed too indirect to be afforded coverage.

The employer's contention that the clients *intended* that the money be turned over to employer and deposited into employer's account, even if proved, was insufficient to bring the claim coverage. This determination is consistent with most New York state and federal case law enforcing similar provisions in fidelity bonds (including financial institution bonds), commercial-crime policies, and employee-theft policies. E&D

ERNSTROM & DRESTE LLP

NEW YORK
180 Canal View Boulevard
Suite 600
Rochester, New York 14623

Visit us online at:
WWW.ERNSTROMDRESTE.COM

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FIRM NEWS

Thomas K. O'Gara recently authored an article for the Spring 2013 ABA Fidelity & Surety Committee Newsletter, titled "Is There Any Choice in the Matter: Are all Surety Claims and Defenses Subject to Arbitration?"