

## Knowing What to Look For

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**You** can increase the odds of maximizing recovery for the surety by quickly identifying contract funds of the principal, as well as nonexempt assets of indemnitors.

# Security Indemnification from the Principal and Indemnitors

The scenario is all too familiar. The principal fails to pay its subcontractors and the surety foots the bill. Maybe the surety is able to secure a judgment against the principal and indemnitors with relative ease. But collecting can be

difficult, even if the indemnitors are solvent. The more assets an indemnitor has, the greater the incentive to conceal those assets. Knowing what to look for and how to secure those assets are the keys to success. It is important to act quickly to begin identifying assets of the principal and indemnitor and to secure any potential assets before they can be dissipated.

A crucial initial source of funds is the defaulted principal's contract funds on other projects. By identifying the principal's other projects, a surety may be able to secure payment of remaining contract funds directly to the surety, thereby precluding the chance that the principal or indemnitors might place the money beyond the surety's reach. If contract funds are not available, other assets that a surety may consider looking for when collecting a judgment include cash, promissory notes, stock certificates, art, jewelry, col-

lectibles, antiques, horses, vehicles, boats, and planes. However, a good first step is looking to the indemnity agreement.

### Recovery from the Principal Cross Collateralization: Surety's Priority Rights to Funds on Other Bonded Projects

The typical indemnity agreement provides the surety with a right to set off loss incurred on claims arising from one bonded contract with the proceeds of a separate bonded project against which no loss or claims were incurred. For example

To facilitate the carrying out of all provisions of this Agreement... the Undersigned assign, transfer and set over to Surety and grant Surety a security interest in all the Undersigned(s)... (a) all the rights of Principal in and growing in any manner out of, all contracts referred to in the Bonds, or in, or growing in any manner out of the Bonds;... (e) any and

all sums that may be due or hereafter become due on account of any and all contracts referred to in the Bonds and all other contracts whether bonded or not in which Principal has an interest...

Courts generally recognize a surety's right to remaining contract funds on other projects bonded by the surety, and will enforce the indemnity agreement.

### Common Obligor Setoff: Sureties Priority Rights to Funds on Non-Bonded Projects

Another avenue for sureties to seek recovery can be the principal's non-bonded contract proceeds. Indeed, many indemnity agreements, as reflected above, will contain an assignment from the bonded principal of all contract proceeds, rather than merely bonded contract proceeds.

Along this line there are cases that acknowledge a surety's rights to contract proceeds derived from a bonded principal's non-bonded contracts with a bonded obligor. Specifically, wherein the surety's principal has proceeds from "other contracts" with a common obligor to the surety's bonded contract, the surety potentially may utilize its equitable subrogation rights to step in front of other secured creditors of the surety's principal. *Merritt Commercial Sav. & Loan, Inc. v. Guinee*, 766 F.2d 850 (4th Cir. 1985), *see also, Travelers Cas. & Sur. Co. of Am. v. Paderta*, No. 10 C 406, 2013 WL 3388739 (N.D. Ill. July 8, 2013).

In *Travelers*, a dispute arose regarding priority to contract funds between the bonded principal's lender, Fifth Third Bank (Fifth Third), and Travelers as to funds held by two bonded obligors, on contracts wherein the principal was not required to secure payment and performance bonds. Fifth Third had filed a UCC-1 Financing Statement and Security Agreement covering the applicable loans, while Travelers relied upon its equitable subrogation rights. The *Travelers* court held that a surety, after performance, acquires the rights of the project owner, including the owner's common law right of set-off. *Travelers* at \*4. The owner's right to setoff, acquired by the surety, trumps the contractor's right to the funds subject to setoff, and thus the bank's rights to the funds acquired via the contractor's assignment. *Id.*

Sureties also have at their disposal multiple opportunities to secure a first priority or non-dischargeable interest in contract

funds from their principal's bonded projects, and in certain instances, non-bonded projects as well.

### Express Trust

The indemnity agreement itself may, and in most cases does, create an express trust in the bonded project's contract proceeds. Most sureties will utilize an indemnity agreement with language substantially similar to the following:

The Undersigned covenant and agree that all payments received for or on account of contract(s) which are bonded by the Surety shall be held as trust funds in which the Surety has an interest. To secure said interest, it is agreed that all monies paid to the Principal and/or Undersigned covered by the Bond(s) are trust funds for the benefit of and the payment of direct labor, materials and services furnished in the prosecution of the work specified in the contract(s) for which the Surety may be or become liable under any of the said Bond(s). The trust funds are specifically reserved as set forth above, and any breach of said duty shall be deemed a breach of the duties or obligations of the Undersigned under this Agreement of Indemnity.

In addition to securing funds for the surety to complete the project, an express trust created by the terms the indemnity agreement makes the indemnitors—generally the bonded principal's owners, spouses, and affiliated companies—fiduciaries of the surety with respect to bonded contract proceeds. *Developers Sur. & Indem. Co. v. Bi-Tech Const., Inc.*, 979 F. Supp. 2d 1307 (S.D. Fla. 2013). Misuse of these funds while acting in a fiduciary capacity, as defined in 11 U.S.C. §523(a)(4) for indemnitor or corporate debts not within the scope of the bonded project, renders debts owed to the surety and arising out of the bonded project non-dischargeable as fraud or embezzlement.

Citing *Matter of Jenkins*, 110 B.R. 74, 76 (Bankr. M.D. Fla.1990), the *Developers* court identified the test for whether the language of an indemnity agreement creates an express trust and, therefore, a fiduciary relationship. According to the court, "the language must create a trust, establish a trust corpus, and show an intent by the parties to create a fiduciary relationship." *Developers*,

979 F. Supp. at 1318. Numerous additional courts have similarly held that language with an indemnity agreement creates an express trust and corresponding fiduciary duty on the part of the principal and its indemnitors, and therefore breach of the same excepts the resulting debt from discharge. *See, e.g., In re Foy*, No. 09-10608, 2010 WL 2584193, (Bankr. D. Kan. June 21, 2010); *In*

### Courts generally

recognize a surety's right to remaining contract funds on other projects bonded by the surety, and will enforce the indemnity agreement.

*re Hastings*, 438 B.R. 743 (Bankr. N.D. Ala. 2008); *In re Herndon*, 277 B.R. 765 (Bankr. E.D. Ark. 2002); *Matter of Jenkins*, 110 B.R. 74 (Bankr. M.D. Fla. 1990). Note, however, that certain states have failed to find the creation of an express trust via the terms of a surety indemnity agreement, or have determined that such trust terms are unenforceable under state law. *See Hanover Ins. Co. v. Hermosa Const. Grp., LLC*, 57 F. Supp. 3d 1389 (N.D. Ga. 2014), (holding Georgia's economic loss rule barred a surety's claim that construction company breached its fiduciary duty). *See also In re Constr. Alternatives, Inc.*, 2 F.3d 670 (6th Cir. 1993) (holding the indemnity agreement failed to create an express trust as proceeds of the bonded contract(s) were not required to be segregated in a separate account).

### Statutory Trust

In addition to express trusts created by indemnity agreements, many state statutes recognize proceeds of a construction contract as trust funds. For example, 11 U.S.C. §523(a)(4) is applicable where statutory trust exists pursuant to N.Y. Lien Law §70, and where fraud or defalcation occurs. *In re Baxter*, 294 B.R. 800 (Bankr. M.D. Ga. 2003).

In *Baxter*, where the court on an initial matter held that a fraudulent finan-



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cial statement provided to the surety did not render a subsequent debt non-dischargeable as the surety had not relied on the same in issuing the applicable bond, the court further held that New York lien laws created a statutory trust for funds received in connection with a contract for public improvement. As a result, the debts incurred by the surety for projects

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in New York State, where the surety had to pay subcontractors after the principal/indemnitors misappropriated funds from the project, were non-dischargeable. *Baxter* at 808.

Similarly, Texas Property Codes have been interpreted to “create a limited trust in favor of the creditor, and if the funds were... diverted to any use other than actual expenses directly related to the construction or repair of an improvement, then they will be held to have been misapplied in a fashion that is actionable under section 523(a)(4).” *In re Faulkner*, 213 B.R. 660, 665 (Bankr. W.D. Tex. 1997) (citing Tex. Prop. Code Ann. §162.031).

#### Recovery from Indemnitors Assets and Accounts of Indemnitors

If contract funds on other projects are unavailable, a surety may be forced to collect its judgment from the indemnitors personally, which can require significant effort and persistence. Once assets or potential assets are identified, the next challenge is securing those assets to be applied to the surety’s judgment. It is important to move quickly to prevent assets from being depleted by the judgment debtor, moved or transferred to a new unknown location, or attached by competing creditors.

Bank statements, check registers, and credit card statements are effective ways to identify sources of income and spending patterns of indemnitors, even if the accounts no longer hold significant funds. It is good practice to identify and to track prior income sources that are no longer being deposited into the account, and to subpoena payment records of routine creditors to determine how the indemnitors-turned-judgment debtors are now paying these bills.

For bank accounts and sources of cash flow, surety judgment creditors can pursue garnishments, which require a third party to pay to the creditor money owed to a judgment debtor. Garnishments are frequently issued to a debtor’s employer to intercept a portion of the debtor’s wages, and to banks to secure funds in savings and checking accounts. However, garnishments can also be used to capture rent owed to the judgment debtors from tenants of investment properties, to collect distributions from limited liability companies, or to collect payments owed to the judgment debtors on promissory notes. This can even be helpful if the indemnitors own other entities that are not indemnitors on the bonds, which may be otherwise unreachable. If the garnishee does not respond to the garnishment, depending on the laws in your state, a surety may be able to obtain a judgment against the delinquent garnishee. With a judgement against a delinquent garnishee, it can open up additional assets that can be attached to satisfy the judgment.

Other accounts, such as ERISA-qualified retirement accounts and bank accounts comprised entirely of money from exempt sources, may not be reachable by a surety if the funds can be traced to an exempt source. *See In re Patterson*, 10-31791, 2010 WL 3606893 (Bankr. N.D. Ohio Sept. 10, 2010). Savvy indemnitors may have exempt income, such as Social Security, accumulate in a dedicated bank account and claim the account exempt, while living off of non-exempt income yet to be identified by the surety. Counsel should carefully evaluate whether the judgment debtor has adhered to the necessary separation of the exempt income from funds from other sources, as the judgment creditor may be able to attach the non-exempt funds.

Although commingling exempt income with non-exempt income does not change

the exempt status of the funds, the mere fact that exempt funds, such as Social Security benefits, are deposited into a bank account does not necessarily shield the entire account from garnishment. With produced or subpoenaed bank statements, the exempt funds can be traced on a “first-in, first-out” basis to identify funds subject to a surety’s garnishment. *In re Moore*, 214 B.R. 628, 631-32 (Bankr. D. Kan. 1997); *NCNB Financial Services, Inc. v. Shumate*, 829 F. Supp. 178 (W.D. Va. 1993), *affirmed* 45 F.3d 427, *cert. denied* 115 S. Ct. 2616, 515 U.S. 1161, 132 L. Ed. 2d 859. Furthermore, once otherwise exempt money is paid out or given away, and is therefore no longer available for the support and maintenance of the judgment debtor, it loses its exempt character. *Edgefield Holdings, LLC v. Gauthier*, No. 4:16CV00726 JLH, 2017 WL 449633, at \*4 (E.D. Ark. Feb. 2, 2017). Note that in many states, funds paid from exempt accounts, such as ERISA retirement accounts, lose their exempt status once they are distributed to the debtor and deposited into the debtor’s account. *See In re Whittick*, 547 B.R. 628, 638 (Bankr. D.N.J. 2016).

Judgment debtors may also have valuable personal property that can be used to satisfy the judgment, though the property available is state-specific. Many types of personal property are exempt from collection, such as personal vehicles, many home furnishings, clothing, and tools used in a trade or profession. *See, e.g., Tex. Prop. Code Ann. §42.002; K.S.A. §60-2304; Me. Rev. Stat. tit. 14, §4422; Mich. Comp. Laws Ann. §600.6023.* Exemptions are often region-specific; for example, Maine exempts a fishing boat and logging equipment, while Texas exempts two horses and 12 head of cattle. *Id.* However, other property, such as artwork, firearms (limited in some states), or non-exempt vehicles, may be worthwhile to attach and sell to satisfy the judgment. To execute on the personal property, coordination with the court and sheriff’s department is key. Be prepared with tow trucks, moving vans, and appraisers to identify and secure valuables quickly.

#### Limited Liability Companies

Indemnitors may also have multiple limited liability companies, which may not be co-indemnitors on the bonds. While a surety cannot reach the assets of these

companies if they are not also judgment debtors, these entities may owe money to the judgment debtor. If the entity is a partnership or a limited liability company, the method for collecting these funds is through a charging order. A charging order charges the judgment debtor’s ownership interest in the company, and pursuant to that order, any funds owed to the judgment debtor by the charged company must be paid to the charging party.

If the entity to be charged is a closely held company, it may be difficult for the surety to confirm that the indemnitor is complying with the charging order. To ensure compliance, propound discovery in aid of execution and request bank statements of the charged entities. Review the bank statements and check transfers between the charged entities and the judgment debtors’ accounts, as well as payments by the charged entities on behalf of the judgment debtors. For example, a judgment debtor may use a limited liability company’s bank account to pay his or her personal obligations, or may use the credit card of a legitimate business to make personal purchases in lieu of taking a salary that could be subject to garnishment. Transfers can happen at any time, therefore it is important to monitor the debtor’s financial transactions periodically and watch for new sources of cash.

Once the surety has identified assets that can be used to satisfy the judgment, seek a court order that the asset be delivered to the surety. Continue to monitor the indemnitors’ financial transactions for violation of charging orders and court orders. Indemnitors may attempt to restructure financial arrangements so they are compensated in different ways that aren’t subject to the existing orders.

#### Fraudulent Transfers

If, in the course of the review of the indemnitor’s financial documents, the surety identifies a transfer of assets or funds from a judgment debtor to an individual or company against whom the surety does not have a judgment, the surety may be able to pursue a fraudulent transfer or fraudulent conveyance action against the transferee. Outside of bankruptcy situations, fraudulent transfer actions are governed by state law, with many states following the Uniform

Fraudulent Transfer Act or its predecessor, the Uniform Fraudulent Conveyance Act.

A fraudulent transfer may occur as an intentional transfer of funds or assets to a non-debtor with the intent to shield the assets from the creditor, or it may occur as a constructive transfer, whereby the debtor transfers assets without receiving reasonably equivalent value in exchange for the transfer. State law may authorize courts to consider other factors of fraud when determining whether a judgment debtor intended to defraud a creditor, including, for example, whether (1) the transfer was to an insider; (2) the debtor retained possession or control of the transferred property after the transfer; (3) the transfer was concealed; (4) the debtor was sued or threatened with suit before the transfer was made; (5) the transfer was of substantially all the debtor’s assets; (6) the debtor absconded; (7) the debtor removed or concealed assets; (8) the value of the consideration the debtor received was reasonably equivalent to the value of the transferred asset; (9) the debtor was insolvent or became insolvent shortly after the transfer was made; (10) the transfer occurred shortly before or after a substantial debt was incurred; and (11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

*White v. Pottorff*, No. 05-14-00675-CV, 2015 WL 302810, at \*4 (Tex. App. Jan. 23, 2015).

For example, a debtor might transfer funds from his or her bank account to the bank account of one of his or her companies and then cause the company to make periodic distributions. By doing this, the debtor prevents the creditor from reaching the full sum of the funds in the bank account with a garnishment, and retains control of the cash. The indemnitor is effectively still able to access his or her cash in smaller amounts. If the indemnitor’s bank account is not subject to a garnishment at the time of transfer, it provides the indemnitor with a window of time to transfer the funds to the account, and then withdraw the cash before the surety is aware of the asset.

A fraudulent transfer action must be brought as a separate lawsuit against the recipient of the funds. If the transferee was aware that the indemnitor planned to

transfer funds away from his or her creditors fraudulently, the surety may also have a conspiracy claim against the transferee. *See Travelers Cas. & Sur. Co. of Am. v. Hunt*, No. 215CV00336TLNCKD, 2016 WL 727285, at \*4 (E.D. Cal. Feb. 24, 2016). In the course of reviewing a debtor’s bank and financial statements and other discovery in aid of execution, watch for information that

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may differ from the indemnitors’ testimony during the debtors’ examinations or depositions. The trail of transfers can be used to impeach the debtor in a subsequent fraudulent transfer action.

The debtor’s financial documents can also be used to prove violations of charging orders against limited liability companies. Bank statements obtained after charging orders have been entered may show transfers from the bank accounts of the charged entities to the judgment debtor. The indemnitor may be using its related company as its personal piggy bank to avoid keeping large amounts of funds in its bank account that would be vulnerable to garnishments. In this situation, the surety can file a motion against the charged entity for its violation of the charging order.

#### Conclusion

Approaching indemnification by quickly identifying and securing contract funds of the principal, as well as nonexempt assets of indemnitors increases the odds that the surety will maximize the amount it is able to recover.