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**FAIR DEBT COLLECTION LAWS AND SURETIES**

**PRESENTED BY:**

**JOHN W. ROURKE  
ANDREA M. CUNNING**  
Reinert & Duree, P.C.  
812 N. Collins  
Laclede's Landing  
St. Louis, Missouri 63102-2174  
314-621-5743

## FAIR DEBT COLLECTION LAWS AND SURETIES

In recent years, many of the surety's traditional rights and defenses under the common law and in equity have been eroded. Sureties trying to enforce or assert these traditional rights and defenses now regularly face claims--such as bad faith, lender liability, domination, and tortious interference with contract—which were rarely asserted, let alone successful (or even legally recognized) in the past. Unfortunately, not only are such claims being asserted more frequently by obligees, principals and indemnitors, but they are being asserted successfully.

In enforcing what may be the most important of their traditional rights—the rights of subrogation and indemnity, do sureties and their counsel stand exposed to yet another area of liability in the form of fair debt collection laws? For the moment, the answer appears to be no.

Although some states have their own fair debt collection laws<sup>1</sup>, the primary law governing fair debt collections<sup>2</sup> is the federal Fair Debt Collection Practices Act (FDCPA).<sup>3</sup> This paper will address the FDCPA and its applicability or inapplicability to sureties. This paper will also briefly discuss Article 9-503 of the Uniform Commercial Code and its applicability to sureties, as well as various other laws that sureties need to be aware of when attempting to enforce their indemnity and subrogation rights.

### The Fair Debt Collection Practices Act

The FDCPA originally became law in 1977. The FDCPA, which was, and is, intended to protect debtors from abusive debt collection practices provides that:

- Requests for information on the location of debtors are strictly regulated;
- Debt collectors cannot communicate with the debtor in connection with the debt at any unusual time or place or place known to be inconvenient to the debtor; moreover, communications before 8 AM and after 9 PM are presumed inconvenient;
- Debt collectors cannot communicate with the debtor if they know the debtor is represented by an attorney, unless the attorney fails to respond within a reasonable amount of time to communications from a debt collector, or unless the attorney consents to direct communications with the debtor;
- Communications with third parties about the debt are prohibited absent permission by the consumer;

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<sup>1</sup> The Uniform Commercial Credit Code (“U3C”), for example, has been adopted, with variations, by a number of the states.

<sup>2</sup> Obviously, the Bankruptcy Code, which will not be addressed in this paper, has a large role in governing debt collection practices.

<sup>3</sup> 15 U.S.C. Section 1692 et seq..

- Debt collectors are required to cease communication with the debtor if the debtor gives notice in writing that he refuses to pay the debt or wants the debt collector to stop communications;<sup>4</sup>
- Harassing, oppressive, or abusive communication is prohibited;
- False or misleading representations are prohibited;
- Certain “unfair practices” are prohibited;
- Debt collectors are required to give a “Miranda warning” in their communications with the debtor that they are attempting to collect a debt and that any information obtained will be used for that purpose;
- Debt collectors are required to send a detailed (as specified in the statute) notice to the debtor in their initial communication with the debtor regarding, among other things, the debtor’s right to dispute the debt;

The FDCPA is a “strict liability” statute and there are virtually no defenses.<sup>5</sup> Moreover, a violation of the FDCPA can result in civil liability for actual damages, statutory damages, costs, attorney’s fees, and possible exposure to administrative enforcement by the Federal Trade Commission.

### **The FDCPA’s applicability to attorneys**

The FDCPA has been a particularly “hot topic” among lawyers in recent years, particularly since *Heintz v. Jenkins*, **115 S.Ct. 1489, 514 U.S. 291, 131 L.Ed. 2d 395 (1995)**, which made it clear that the FDCPA is applicable to attorneys, at least those who are regularly engaged in consumer debt collection litigation on behalf of their creditor clients. *Heintz* brings into question the holding in *Firemen’s Insurance Company of Newark, New Jersey. v. F. Keating*, **753 F.Supp. 1137 (D. NY 1990)**, one of the few reported cases involving a surety and the FDCPA. In that case, a surety employed a law firm to bring actions against partnership investors to compel compliance with indemnification agreements. The investors claimed that the firm had violated the FDCPA. The court held that the law firm could not be a “debt collector” as defined by the FDCPA with respect to its representation of the surety. The court stated that the Act “applies to attorneys when they are collecting debts, not when they are performing tasks of a legal nature... (t)he act only regulates the conduct of debt collectors, it does not prevent creditors, through their attorneys, from pursuing any legal remedies available to them.” *Id. at 1142, citing Rep. Annunzio*. Under *Heintz*, the surety’s attorneys

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<sup>4</sup> There are three exceptions to this: (1) to advise the debtor that the debt collector’s further efforts are being terminated; (2) to notify the debot that the debt collector/creditor may invoke specified remedies which are ordinarily invoked by such debt collector or creditor; and (3) to notify the debtor that the debt collector/creditor intends to invoke a specified remedy.

<sup>5</sup> Although the FDCPA allows for a “bona fide error” defense, the courts have generally interpreted this to apply only to clerical errors.

would likely be “debt collectors” within the FDCPA. Nevertheless, notwithstanding **Heintz**, the law firm would likely be able to successfully raise the defense that the debt which it was seeking to recover was a commercial debt and therefore not covered by the FDCPA.

- From a practicing attorney’s standpoint, the FDCPA is particularly troublesome in that it:
  - In some cases it trumps state law, including rules of civil procedure, rules of ethics, and state substantive law regarding the methods an attorney can employ to represent his client in collecting a debt
  - The FDCPA restricts the choice of venue in collection actions, contrary to what state law may provide
  - The FDCPA’s coverage extends to such activities as filing and pursuing a lawsuit, mortgage foreclosure, UCC practice, judgment collection, and conducting of a UCC sale.

### **Applicability of the FDCPA to Sureties**

Notwithstanding the possible liability imposed by the FDCPA, sureties can take comfort in that the FDCPA generally will not apply to them, since most surety cases involve commercial debts not covered by the FDCPA. Moreover, sureties and their attorneys generally do not qualify as “debt collectors” within the coverage of the FDCPA. Finally, even when sureties are involved in the rare non-commercial transactions, the FDCPA will generally not apply due to “non-consensual transaction” and “originator” exceptions to the FDCPA.

### **Neither Commercial debts nor Non-Consensual debts are covered by the FDCPA**

The FDCPA applies to “consumer debts”, which refers to an “obligation of a consumer to pay money arising out of a transaction which the money, property, insurance or services which are the subject of the transaction are primarily for personal, family, or household purposes.” **15 U.S.C.A. s. 1692a(5)**. Thus, commercial debts—the primary type of debt surety companies are concerned with—are not covered under this Act. However, the distinction between “consumer debts” and “commercial debts” can sometimes be unclear, as is illustrated by several cases. In ***Bloom v. I.C. Systems, Inc.*, 972 F.2d 1067 (9<sup>th</sup> Cir. 1992)**, a loan between two friends for investment purposes was reported to a collection agency by an employee of the lender. The debtor filed suit against the collection agency for violating the FDCPA. The court held that “(t)he fact that a loan is informal or that the lender may have loaned the money for personal reasons does not make it a personal loan under the FDCPA”, and ruled the FDCPA inapplicable. ***Id. at 1067***.

However, in ***Bass v. Stopler, Koritzinsky, Brewster*, 111 F.3d 1322 (7<sup>th</sup> Cir. 1997)**, a joint checking account holder sued a law firm claiming that the firm’s attempts to collect on a dishonored check by the other account holder violated the FDCPA. The Seventh Circuit held that the payment obligation arising from the dishonored check created a “debt” which is

protected under the FDCPA.<sup>6</sup> The law firm had argued that the FDCPA only applied to debts arising from an offer or an extension of credit. The Seventh Circuit stated: “we see no language in the Act’s definition of ‘debt’ that mentions, let alone requires, that the debt arise from an extension of credit.” *Id.* at 1325. Moreover, “(a)s long as the transaction creates an obligation to pay a debt is created.” *Id.*

The defendant law firm had relied on *Zimmerman v. HBO Affiliate Group*, 834 F.2d 1163 (3d Cir. 1987), in support of its position that the FDCPA did not apply to the conduct at issue because an extension of credit was required under the Act.<sup>7</sup> The **Bass** court responded that **Zimmerman** stands for the proposition that “the term ‘transaction’ in the definition of debt is not broad enough to include asserted tort liability.” **Bass**, at 1326. Thus, the court concluded that “although a thief undoubtedly has an obligation to pay for the goods or services he steals, the FDCPA limits its reach to those obligations to pay arising from consensual transactions where parties negotiate or contract for consumer related goods or services.” **Bass**, at 1326.<sup>8</sup> The **Bass** court went on to distinguish **Zimmerman** and held that the definition of “debt” according to the FDCPA does not require the extension of credit. The **Bass** court reaffirmed **Zimmerman**’s holding that “debt” does not include an obligation to pay derived from theft.<sup>9</sup>

Per **Bass** and **Zimmerman**, it is clear that for a “debt” to implicate the FDCPA, it must arise out of a transaction involving a consensual transaction. *15 U.S.C.A.1692a(5)*. Thus the FDCPA would not be applicable to one who embezzles from an employer and uses the funds for personal purposes, notwithstanding the fact that an embezzler clearly owes money to his victim. Accordingly, the FDCPA would be inapplicable to, for example, a fidelity bond surety or insurer which pursued an embezzler on a claim which it obtained by virtue of assignment or subrogation from its bond principal or insured. This is in keeping with the purpose of the Act, which is concerned with remedying the sole wrong of debt collector abuse. **Bass**, at 1330. Hence, any theft or stealing funds for personal use results in the loss of protection under the FDCPA.

### **Sureties are not “debt collectors” within the coverage of the FDCPA**

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<sup>6</sup> See also *Wegman’s Food Markets, Inc. v. Scrimpsheer*, 17 B.R. 999. Collection bureau was subject to the Fair Debt Collection Practices Act for seeking to collect incorrect amount of debt.

<sup>7</sup> In *Zimmerman*, the issue was whether the defendant cable television companies, in demanding that plaintiff pay for allegedly pirated microwave television signals, were seeking to collect a “debt” within the meaning of the FDCPA.

<sup>8</sup> The **Zimmerman** court then reasoned that since transaction was not consensual, it therefore was not truly a “debt” for the purposes of the FDCPA.

<sup>9</sup> See also, *Shorts v. Palmer*, 155 F.R.D. 172 (D. OH. 1994). “Customer” brought suit under the FDCPA for merchant’s failure to give required notices in connection with its attempts to enforce its civil damage claim for damages sustained as a result of “customer’s” attempted cigar theft. The FDCPA was found inapplicable because the “debt” was not incurred by a “consumer.”

The FDCPA is limited to the “debt collector”, which is defined as one who “regularly collects or attempts to collect, directly or indirectly, (consumer) debts owed...another.”<sup>10</sup> **15 U.S.C.A. s. 1692a(6)**. Since most commercial surety companies are not in the “consumer debt” business, neither they nor their attorneys are covered by the FDCPA.

### **The Originator Exception**

The FDCPA also does not apply to third parties if the debt originated from them. For example, a mother who executed a contingent note and mortgage as part of a bail bond transaction on her daughter’s behalf brought suit against the bail bondsman and the bail bond surety for trying to collect the debt after the daughter failed to appear as required by law. **S. Buckman v. American Bankers Insurance Company of Florida, 115 F.3d 892 (11<sup>th</sup> Cir. 1997)**. The court found that the FDCPA did not apply due to the “originator exception.” That is to say that the term “debt collector” under the FDCPA does not include “any person collecting or attempting to collect any debt owed or due or asserted to be owed or due another to the extent such activity...concerns a debt which was originated by such person.” **15 U.S.C.A. s.1692a(6)(F)(ii)**. The court decided that the originator exception applied to the bail bondsman since he played a significant role in the transaction from the beginning and is thus covered by the exception to the FDCPA.

In sum, at the present, the Fair Debt Collection Practices Act is rarely applicable to surety companies.

### **The Uniform Commercial Code**

General Indemnity Agreements (GIAs) often act as both a security agreement and a financing statement under the Uniform Commercial Code (UCC), thus enabling the surety to obtain and perfect a security interest in funds and property of its bond principal (“the debtor” under UCC parlance). Nevertheless, notwithstanding its security interest, the surety has to take additional steps to enforce its security interest as to its principal and to other claimants. Obviously, this can be done by filing a lawsuit and joining in any other potential claimants to the funds or property. However, under many circumstances, this is not a preferred solution since funds, equipment, materials and other property may be needed to complete the project immediately. In these circumstances a surety may be able to obtain the funds, equipment, materials and other property without an injunctive order. The funds may be able to be obtained by contacting the owner(s) and pointing out to the owner(s) its security interest in and assignment of such funds. More problematic, however, is how the surety goes about obtaining equipment, materials and other property of its bond principal through “self-help”.

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<sup>10</sup> In **H. Arnold v. Truemper, 833 F.Supp. 678 (D. IL 1993)**, bank customers filed an action against their bank, alleging violations of the FDCPA by the bank when the bank complained to police regarding “stolen” money that the bank had previously mistakenly credited to customers’ accounts. The court held that the FDCPA did not apply to the bank’s report to the police regarding possible theft of funds since the debt arose by a mistake at the bank, the bank did not offer or extend credit to customers, and since the police were not considered “debt collectors” under the FDCPA since they were not in the business of the regular collection of debts.

Unlike the FDCPA, the UCC applies to commercial transactions. Article 9 of the UCC governs how a surety goes about obtaining and perfecting a security interest. Section 9-503 of the UCC, which governs a secured party's right to take possession after default, provides:

“Unless otherwise agreed a secured party has on default the right to take possession of the collateral. In taking possession a secured party may proceed without judicial process if this can be done without breach of the peace or may proceed by action. If the security agreement so provides the secured party may require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties. Without removal a secured party may render equipment unusable, and may dispose of collateral on the debtor's premises under Section 9-504.”

Thus, the surety may repossess materials, equipment, and other property, as long as this can be done without a “breach of the peace”. If, however, the surety's actions result in a “breach of the peace”<sup>11</sup>, the surety is subject to civil<sup>12</sup> or even criminal liability. Moreover, the surety may even be deprived of a deficiency judgment—i.e. it could lose the right to the rest of its indemnity if its self-help repossession attempts in a breach of the peace.

In sum, a surety attempting to minimize its losses by repossessing materials, equipment, and other property of its bond principal in which it has a security interest, should either obtain consent of its bond principal to the repossession, or be extremely careful that it does not “breach the peace”. If it fails to do so, it jeopardizes its indemnity rights. For this reason, quite often discretion is the better part of valor and the surety should forego self-help repossession and obtain repossession judicially by filing for injunctive relief.

#### **Other Laws which sureties may encounter in attempting to enforce their indemnity rights**

Apart from the traditional defenses raised by bond principals and indemnitors against sureties and the more modern theories mentioned at the beginning of this paper (bad faith, lender liability, domination, tortious interference, etc.), sureties are sometimes faced with a wide variety of other laws interposed as defenses or counterclaims. Quite often inapplicable,

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<sup>11</sup> “Breach of the peace” is discussed in White and Summers, *Uniform Commercial Code* (1988), Section 25-6, as follows:

“The meaning of the phrase ‘breach of the peace’ has been the subject of countless judicial opinions. The draftsmen knowingly chose this well-worn phrase, and did not define it anew. Accordingly the numerous pre-Code cases are still good law. In most cases, to determine if a breach of the peace has occurred, courts inquire mainly into: (1) whether there was entry by the creditor upon the debtor's premises; and (2) whether the debtor or one acting on his behalf consented to the entry and repossession.

In general, the creditor may not enter the debtor's home or garage without permission. The debtor's consent, freely given, legitimates any entry; conversely, the debtor's physical objection bars repossession even from a public street. This crude two-factor formula of creditor entry and debtor response must, of course, be refined by at least a consideration of third party response, the type of premises entered and possible creditor deceit in procuring consent.”

<sup>12</sup> In addition to compensatory and punitive damages, Section 9-507 of the UCC provides additional penal damages.

they are raised nonetheless and include federal statutes such as the Truth In Lending Act (TILA)<sup>13</sup> and the regulations promulgated thereunder (particularly “Regulation Z”<sup>14</sup>), the Fair Credit Reporting Act (FCRA)<sup>15</sup>, various Federal Trade Commission regulations.

An example of this is the **Buckman v. American Bankers Insurance Co. of Florida** case, cited supra.. In that case, the indemnitor was a mother who had executed a contingent note and mortgage and indemnity agreement as part of a bail bond transaction on her daughter’s behalf. She sued the bail bondsman and the bail bond surety, asserting claims under TILA and the FDCPA after they tried to collect from her when her daughter failed to appear at court. The court’s discussion in holding that the mother did not have a cause of action is particularly helpful and supportive of the proposition that TILA does not apply:

“We believe it strains credibility to say that an indemnitor on a bail bond agreement is “shopping for credit” when she agrees to the terms of a bail bond agreement. Instead, she is engaging in a standard bail bond transaction: she agrees to be obligated to the surety should the accused fail to appear in court at the scheduled time. Stated differently, we do not believe that executing an agreement to indemnify a bail bond surety and providing a note and mortgage to facilitate any indemnification that may become necessary is the “extension of credit” as that phrase is commonly understood or as used in the pertinent statute and regulations...

“We think that, within the context of posting a bail bond, a contingent note given in conjunction with an indemnification agreement (as well as a mortgage given as collateral on the note) is like a letter of credit. The note (and mortgage) is a promise to pay upon the occurrence of a particular contingency which facilitates the posting of a bail bond by providing assurances of prompt payment (indemnification) to both the bail bondsman (Ace) and the bond surety (ABIC) in the event that the bail bond is forfeited, as well as providing the obligee on the bail bond (the State of Florida) with assurances that the bail bond indemnitor has a strong financial incentive to ensure that the accused will appear in court at her scheduled time.”

State insurance codes also provide fertile grounds for the creative indemnitor’s lawyer seeking to raise plausible defenses to a surety’s indemnity action. These--usually inapplicable or at least irrelevant--include state Unfair Methods of Competition and Unfair and Deceptive Acts and Practices acts, unfair practices laws, and Insurance Information and Privacy Protection laws.

Sureties need to be aware of these laws and the propensity of these to be interposed as grounds for defense. Nevertheless, by and large these laws are inapplicable and should not cause sureties and their attorneys too much anguish.

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<sup>13</sup> 15 U.S.C. Section 1601, et seq..

<sup>14</sup> 12 C.F.R. Pt. 226.

<sup>15</sup> 15 U.S.C. Section 1681 et seq..

## **Conclusion**

At least for the present, sureties and their attorneys should not be overly concerned about the FDCPA and the various other fair debt collection practices laws when enforcing sureties rights of indemnity and subrogation since these laws are generally inapplicable to the typical commercial surety company.

**JOHN W. ROURKE**  
**Biographical Sketch**

John W. Rourke is a shareholder in the St. Louis law firm of Reinert & Duree, P.C.. His practice emphasizes fidelity and surety bond claims and litigation, construction litigation, and commercial law. He is a graduate of the University of Virginia and the University of Missouri School of Law.

Mr. Rourke is a member of the American Bar Association, the Missouri Bar, the Illinois State Bar Association, the Chicago Bar Association, and the Bar Association of Metropolitan St. Louis. He has been a contributor to or co-author of a number papers pertaining to fidelity law, surety law and construction law.

**ANDREA M. CUNNING**  
**Biographical Sketch**

Andrea M. Cunning, a Summer Associate for Reinert & Duree, P.C. is a 1995 graduate, Cum Laude, of Kenyon College. She is currently a law student at Washington University School of Law (J.D. expected May 1998).

## **BERNARD A. REINERT**

### **Biographical Sketch**

Bernard A. Reinert is a Principal shareholder, the Chairman and the President of the St. Louis law firm, Reinert & Duree, Professional Corporation. The firm is engaged in the general practice of law. Its practice includes insurance coverage litigation, civil litigation arising out of property and casualty claims, subrogation claims, litigation, medical *malpractice* litigation, products and general liability litigation and commercial litigation including particularly, but not limited to, franchise litigation. The firm specializes in fidelity bond, surety bond and construction contract matters.

Mr. Reinert was admitted to the Bar in Missouri in 1962 and in Illinois in 1963. He went to undergraduate school at St. Mary's Mission Seminary College at Techny, Illinois and at St. Louis University in St. Louis, Missouri and graduated with a Bachelor of Arts degree in 1958. He graduated from St. Louis University School of Law in 1962 with a Bachelor of Laws degree. He was a law clerk to United States District Judge Omer Poos in Springfield, Illinois in 1962-1963.

Mr. Reinert is a member of the American Bar Association, the Missouri Bar, the Illinois State Bar Association, and the Bar Association of Metropolitan St. Louis. He has been a member of the Torts and Insurance Protection Section and of the Fidelity and Surety Law Committee for approximately thirty years. He has served several terms as, and is presently, a Committee Vice-Chairman. He has participated in many of the Committee's programs, chaired a program in San Francisco, and presented papers at more than a dozen industry programs. A notable paper which Mr. Reinert has authored is entitled "Duty of the Performing Surety to Bond Principal and Indemnitors: Good Faith". Another paper which he presented to the Committee dealt with the surety's rights in subrogation to bonded contract funds before and after the Federal Tax Lien Act of 1966. Mr. Reinert has participated in other activities of the Committee, including the Commercial Blanket Bond National Institute, and the Financial Institution Bond National Institute (London, 1992) and the Commercial Blanket Bond Annotation Project. He has participated in updating the Banker's Blanket Bond Annotation. He has participated in the publication of the Fidelity And Surety News (FSN) under the editorial sponsorship of St. Louis University School of Law. He serves as the FSN Subcommittee's liaison to the FSN Editor. Mr. Reinert participated in the "Subrogation Project" culminating in the August, 1990 ABA Annual Meeting Program the Fidelity and Surety Law Committee entitled "The Subrogation Rights of the Contract Bond Surety" presenting a paper entitled "Elements of Proof in the Contract Bond Surety's Subrogation Action to Recover the Bonded Contract Funds". Mr. Reinert and his firm have participated in the Northeast Surety and Fidelity Claim Seminar for the past 6-7 years, contributing two papers annually including this year, 1997.

Mr. Reinert lives in the St. Louis suburban community called Kirkwood and has been active in community affairs there, particularly as a member of the Kirkwood R7 School District Board for 15 years, 1976 to 1991. He presently serves as Chairman of the City of Kirkwood Civil Service Commission.