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A Primer On Extra Contractual Exposure Other Than Bad Faith - Do Your Principal's Ideas For Mitigating Losses Pass The Smell Test?

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A Primer On Extra Contractual Exposure Other Than Bad Faith - Do Your Principal's Ideas For Mitigating Losses Pass The Smell Test?

This paper is written as a primer, i.e., an introduction to certain topics. The topics are federal and state statutes that can create serious civil and criminal liability for the unwary, the unwise, or the unscrupulous. In recent years, causes of action for "bad faith" or other torts arising out of claims handling have attracted a lot of attention and have been the subject of many publications. The civil and criminal liabilities discussed herein are distinct from contractual obligations under the bonds and extra-contractual exposure for bad faith or other tort causes of action.

It is certainly not our intention to say that a surety professional would or could ever be found to have violated any one of these statutes. Our intent is to raise awareness about these statutes so that when a surety's principal presents a proposal for mitigating possible losses, the surety professional understands <u>all</u> of the risks that could be implicated by the proposal. The surety professional should give the proposal a thorough "smell test" and if it fails reject the proposal or work on a less objectionable alternative.

Generally, this paper will address three types of statutes: (1) preference actions and avoidance actions under the United States Bankruptcy Code; (2) state law fraudulent transfer acts; and (3) federal fraud statutes, including the Racketeer Influenced and Corrupt Organization Act (commonly known as RICO). Of course, this list is just the beginning. State civil or criminal statutes may be implicated by the principal's proposal. Other federal statutes may also apply, from environmental to securities laws. It is impossible to list them all, instead we have focused on the broadest.

A surety claims professional should view any proposal from its principal from perspectives other than just minimizing losses. The surety professional should first identify who may be interested in challenging the surety's actions. Numerous parties may have an interest in seeking to recover from the surety for any loss they have suffered as a result of the principal's actions. The possibilities include bankruptcy trustees, other creditors of the principal, the indemnitors, the obligee, and state and federal prosecutors. The second question is how the parties would assert claims against the surety if the surety proceeds with the principal's proposal. The statutes discussed herein create possible means for these parties to assert alleged claims and causes of action neither created nor covered by the bonds issued by the surety.

For each of these statutes, this primer will set forth the basic text of the statute, the elements of a cause of action under the statute, the damages/penalties, and the basic defenses. We do not try to apply any of the statutes to any particular set of facts. If the reader wants more information on a specific statute, we have cited articles that discuss specific statutes in greater detail in the footnotes.

I. BANKRUPTCY CODE RISKS

A. Avoidance of Preferences

The Bankruptcy Code[1] contains two sections that are particularly useful for a trustee trying to avoid transfers[2] from the principal to another party. The first of these, Section 547, allows a trustee to avoid pre-bankruptcy petition transfers by the debtor of any interest in property.[3] Subsection (b) provides the elements for a cause of action for avoiding a preference:

> Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property--(1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made--(A) on or within 90 days before the date of the filing of the petition; or (B) between 90 days and one year before the date of the filing of the petition if such creditor at the time of such transfer was an insider; and (5) that enables such creditor to receive more than such creditor would receive if--(A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title. [4]

All of the elements must be met to successfully avoid a preference.[5] If the trustee is successful in avoiding the preference, that avoided transfer will be preserved for the benefit of the estate.[6] The trustee can recover from the transferee or even subsequent transferees.[7]

The most common defenses to an action to avoid a preference are found in subsection (c) and relate to contemporaneous exchanges, ordinary course payments, and new value:

(c) The trustee may not avoid under this section a transfer-

(1) to the extent that such transfer was-

(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

(B) in fact a substantially contemporaneous exchange;

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[1] 11 U.S.C. §§ 101-1001 is commonly referred to as the Bankruptcy Code. See generally T. Scott Leo "Bankruptcy Considerations and Bond Defaults" in Bond Default Manual 2nd Ed. (ABA 1995 Duncan L. Clore, ed.); Joanne Brooks and Robert Carney "The Impact of the Bankruptcy Code on the Surety's Pursuit of Salvage" in Salvage by the Surety (ABA 1998 George J. Bachrach ed.) For further discussion of Bankruptcy Code issues see Julia M. Blackwell "The Effect of the Principal's Filing For Bankruptcy in The Law of Suretyship (Edward Gallagher ed. ABA 1993)/

[2] The terms "avoid" and "voidable" are used interchangeably in the context of preferences and fraudulent transfers but are not to be confused with the term "void". *See* FDIC v. Davis, 733 F.2d 1083, *citing* Fischer v. Pauline Oil & Gas, 309 U.S. 294, 301-02, *reh'g denied*, 309 U.S. 697 (1940). (A preference is "voidable" and not "void". It requires affirmative action on the part of the party seeking to avoid the preference.).

[3] "Preference" in that one or more of the debtor's creditors is put in a better position than the debtor's other creditors with regard to the debtor's assets.

[4] 11 U.S.C. § 547(b).

[5] Ranier & Associates v. Waldschmidt, 706 F.2d 171, 172 (6th Cir. 1983), *cert. denied,* 464 U.S. 935 (1983).

[6] 11 U.S.C. § 551. *See also* Moore v. Bay, 284 U.S. 4 (1931).

[7] 11 U.S.C. § 550 (liability of transferee of avoided transfer).

(2) to the extent that such transfer was-

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms;. . . .

* * * *

(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor-

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of which new value the debtor did not make or otherwise unavoidable transfer to or for the benefit of such creditor.[8]

Two other defenses to the avoidance of a preference are the judicially created doctrine of "earmarking" and pre-petition set-offs. "Earmarking" is when a third party makes a loan to the debtor for the debtor to satisfy a particular creditor. The funds do not become part of the debtor's assets and the transfer is not voidable.[9] A pre-petition set-off is an exception to the rule of preferences.[10] It is regarded as a cancellation of mutual debt and not a preferential transfer because no "transfer" has been made.[11] There are four elements to a set-off defense:

(1) a debt owed by a creditor to the debtor that arose pre-petition,
(2) a claim by the creditor against the debtor that arose pre-petition,
(3) the debt and the claim are mutual obligations, and
(4) there is a right to a set-off under non-bankruptcy law.[12]

The determination of the party's right to a set-off is within the discretion of the bankruptcy court.[13]

A final possible defense by a party seeking to defeat an avoidance action is in rebutting the presumption that the debtor was insolvent at the time of the preferential transfer, but it will be a rare circumstance when this defense will prevail.[14]

B. Fraudulent Transfers

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8 11 U.S.C. § 547(c).
9 In re Interior Wood Products Co., 986 F.2d 228, 231 (8th Cir. 1993).
10 In re Fairchild Plantation, Inc., 447 B.R. 946 (Bankr. E.D. Arkansas 1992).
11 In re Madcat Two, Inc., 127 B.R. 206 (Bankr. E.D. Arkansas 1991)..
12 In re Holder, 182 B.R. 770 (Bankr. M.D. Tennessee 1995).
13 In re Aquasport, Inc., 155 B.R. 245 (Banks. S.D. Fla. 1992).
14 There is a rebuttable presumption of insolvency in a preference action. 11 U.S.C. § 547(c). *See* Lawson v. Ford Motor Co., 78 F.3d 30, 34 (2d Cir. 1996).

Section 548 of the Bankruptcy Code allows a trustee to avoid any transfer of property by the debtor that is an attempt to conceal assets from rightful creditors. As seen in the list of elements for a cause of action for fraudulent transfer, the fraudulent transfer can be committed either with actual intent or constructive intent:

> (a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition; if the debtor voluntarily or involuntarily-
>
> (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted or
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> (2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
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> (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
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> (ii) was engaged in business or transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital or
>
> (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.[15]

Because of the difficulty often involved in determining intent, courts often use what are known as "badges of fraud", that is, circumstances that cast suspicion upon a transfer and indicate an attempt by the debtor to hinder, delay, or defraud creditors.[16]

The trustee may recover from the initial transferee or an immediate or mediate transferee of the initial transferee.[17] Section 548(c) protects the rights of a bona fide purchaser or other bona fide transferee to the extent the purchaser or transferee gave value for the transfer.:

> Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the

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[15] 11 U.S.C. § 548(a).
[16] Kurtz v. Wolf, 845 F.2d 842, 846 (9th Cir. 1988).
[17] 11 U.S.C. § 550 (a), (b).

debtor in exchange for such transfer or obligation.[18]

Another defense to a cause of action under section 548 is that the one year statute of limitations has run.[19] However, the Bankruptcy Code allows the trustee to pursue remedies any other applicable law such as state law regarding fraudulent transfers, discussed next. The trustee may be able to rely upon a state law statute of limitations.[20]

II. STATE LAWS CONCERNING FRAUDULENT TRANSFERS

On the state level, there are three types of statutes concerning fraudulent transfers. Most of the states have adopted the recently promulgated Uniform Fraudulent Transfer Act (the UFTA).[21] The Uniform Fraudulent Conveyance Act (the UFCA)[22] is the law in five states[23] and the Virgin Islands, while a few have adopted neither and have their own statutory or judicial rules concerning fraudulent transfers.[24] This discussion will focus on the UFTA.[25]

The UFTA distinguishes between two types of fraudulent transfers. The first are transfers that are fraudulent to both present and future creditors whereas the second type is fraudulent only as to present creditors. Transfers made or obligations incurred by a debtor are fraudulent as to present and future creditors if they are made with actual intent to hinder, delay, or defraud any creditor of the debtor or are made without receiving a reasonably equivalent value of any exchange for the transfer or obligation and the debtor was either engaged or about to be engaged in a business for which the remaining assets were unreasonably small or intended to incur debts beyond the debtor's ability to pay as they became due.[26] Transfers are fraudulent if made with actual intent to defraud or with lack of fair consideration and an inability to pay business debts. The UFTA sets forth various factors to consider in determining actual intent to defraud, but not all factors must exist to prove intent. Those factors are as follows:

(1) the transfer or obligation was to an insider;

(2) the debtor retained possession or control of the property transferred after the transfer;

(3) the transfer or obligation was disclosed or concealed;

(4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

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18 11 U.S.C. § 548(c).

19 11 U.S.C. § 548(a).

20 11 U.S.C. § 544(b).

21 UNIF. FRAUDULENT TRANSFER ACT, §§ 1-13, 7A U.L.A. 643 (West 1985 & Supp. 1998). As of 1998, thirty-seven states have adopted the UFTA.

22 UNIF. FRAUDULENT CONVEYANCE ACT, §§ 1-14, 7A U.L.A. 430 (West 1985 & Supp. 1998).

23 As of 1998, the five states that continue to use the UFCA with state modifications are Maryland, Michigan, New York, Tennessee, and Wyoming.

24 These states are Louisiana, Georgia, South Carolina, Kentucky, Alaska, Mississippi, Virginia, and Kansas. For an example of fraudulent conveyance in one of these states, See VA. CODE ANN. § 55-80 (Michie 1995).

25 For discussions of fraudulent transfer laws, see James D. Ferrucci and Scott D. Baron, "The Surety's Claims Against Third Parties" in Salvage By The Surety (G. Bachrach ed. ABA 1998); Lawrence Lerner and Keith Witten "Salvage/Subrogation Considerations" in Bond Default Manual (D. Clore ed. ABA 1995).

26 See UFTA § 4(a).

(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 received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

(9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

(10) the transfer occurred shortly before or shortly 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.[27]

The UFTA also provides that certain transfers are fraudulent as to present creditors (but not future creditors). There are two types of transfers fraudulent as to present creditors. The first is a transfer made without receiving a reasonably equivalent value in exchange when the debtor was insolvent at that time or became insolvent as a result of the transfer or obligation.[28] The second is a transfer made to a insider for an antecedent debt when the debtor was insolvent and the insider had reasonable cause to believe that the debtor was insolvent.[29] A classic example of this type of transfer is a repayment of an alleged officer loan.

The UFTA prescribes the remedies available to creditors, but each state may have adopted different remedies so the particular state statute should be closely addressed.[30] In particular, the creditor can obtain avoidance of the transfer to the extent necessary to satisfy the creditor's claim, may be able to attach the asset transferred or obtain equitable relief such as injunctions against further dispositions of the property or appointment of a receiver. A creditor is entitled to recover against the transferee of a fraudulent conveyance the value of the asset transferred or the amount necessary to satisfy the creditor's claim, whichever is less.[31]

A transferee has certain defenses and protections prescribed in the statute. The UFTA provides protection for transferees who take in good faith and for a reasonably equivalent value or subsequent transferees.[32] A good faith transferee is also entitled to either a lien on the asset transferred or a reduction in the amount awarded to the creditor to the extent of the value given by the transferee to the debtor for the transfer.[33] Transfers to insiders may not be avoidable if the

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27 See UFTA § 4(b).
28 See UFTA § 5(a).
29 See UFTA § 5(b).
30 See UFTA § 7.
31 See UFTA §8(b).
32 See UFTA §8.
33 See UFTA §8(d).

insider gave new value or if it was made in the ordinary course of a business.[34]

Finally, the UFTA provides various statutes of limitations depending upon the section of the UFTA under which the creditor is proceeding. The statute of limitations can be as short as one year after the transfer, and each state may have adopted modifications to the UFTA limitations sections.[35]

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34 See UFTA §8(f).
35 See UFTA § 9.

III. FEDERAL FRAUD STATUTES

A. RICO

RICO[36] is a broad statute that provides for criminal penalties[37] and civil damages[38] for racketeering activity. The Government must prove five elements in a RICO case:

> (1) there must be the existence of an enterprise,
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> (2) the defendant must be associated with the enterprise,
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> (3) the defendant must have participated in the affairs of the enterprise,
>
> (4) there must be a pattern of racketeering activity, and
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> (5) the enterprise must be shown to have an effect on interstate or international commerce.[39]

A civil plaintiff must prove, in addition to these elements, that the activity caused injury to her business or property.[40] An enterprise is any individual, partnership, corporation, association, or other legal entity as well as any union or group of individuals associated in fact although not a legal entity.[41] Section 1961 of RICO enumerates the types of racketeering activities:

> (1) "racketeering activity" means (A) any act or threat involving murder, kidnapping, gambling, arson, robbery, bribery, extortion, or dealing in narcotic or other dangerous drugs, which is chargeable under State law and punishable by imprisonment for more than one year; (B) any act which is indictable under any of the following provisions of title 18, United States Code: Section 201 (relating to bribery), section 224 (relating to sports bribery), sections 471, 472, and 473 (relating to counterfeiting), section 659 (relating to theft from interstate shipment) if the act indictable under section 659 is felonious, section 664 (relating to embezzlement from pension and welfare funds), sections 891-894 (relating to extortionate credit transactions), section 1084 (relating to the transmission of gambling information), section 1341 (relating to mail fraud), section 1343 (relating to wire fraud), section 1503 (relating to obstruction of justice), section 1510 (relating to obstruction of criminal investigations), section 1511 (relating to the obstruction of State or local law enforcement), section 1951 (relating to interference with commerce, robbery, or extortion), section 1952 (relating to racketeering), section 1953 (relating to

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36 18 U.S.C. §§ 1961-1968. See generally Stephen D. Braun and Alan A. Lieberman "RICO Basics: A Primer" 35 Vill. L. Rev. 865 (1990).
37 18 U.S.C. § 1963.
38 18 U.S.C. § 1964.
39 18 U.S.C. § 1962. See, e.g., United States v. Hooker, 841 F.2d 1225 (4th Cir. 1988).
40 18 U.S.C. § 1964 (c). See, e.g., Jackson County Federal S&L Ass'n v. Maduff Mortgage Corporation, 649 F. Supp. 6 (D. Colo. 1986).
41 18 U.S.C. § 1961(4).

> interstate transportation or wagering paraphernalia), section 1954 (relating to unlawful welfare fund payments), section 1955 (relating to the prohibition of illegal gambling businesses), sections 2314 and 2315 (relating to interstate transportation of stolen property), sections 2341-2346 (relating to trafficking in contraband cigarettes), sections 2421-24 (relating to white slave traffic), (C) any act which is indictable under title 29, United States Code, section 186 (dealing with restrictions on payments and loans to labor organizations) or section 501(c) (relating to embezzlement from union funds), or (D) any offense involving fraud connected with a case under title 11, fraud in the sale of securities, or the felonious manufacture, importation, receiving, concealment, buying, selling, or otherwise dealing in narcotic or other dangerous drugs, punishable under any law of the United States.[42]

Mail fraud, wire fraud, and fraud under the Bankruptcy Code will serve as predicate acts for a RICO cause of action.[43]

The United States Attorney General has certain investigative rights including a right based upon reasonable belief to demand any persons suspected of racketeering activity to produce material including documents for examination. The U.S. District Courts have jurisdiction to prevent and restrain violations of RICO, including ordering any person to divest any interest in the enterprise, imposing reasonable restrictions on the future activities or investments of the person, or order dissolution or reorganization of the enterprise.[44]

A civil plaintiff injured in his or her business or property by reason of a RICO violation may sue therefor in an appropriate United States District Court and "shall recover three-fold the damages he sustains and the cost of suit, including a reasonable attorney's fee."[45] Thus, a successful RICO plaintiff can recover treble damages and attorney's fees.

As for defenses to a RICO action, a defense that claims that state procedural law (for example, the statute of limitations has run) precludes the enforcement of RICO will not work.[46] However, there are three other possible defenses that have been considered by courts. The first of these defenses is that the plaintiff participated or benefited by the activity.[47] The second possible defense is that of legislative immunity.[48] The third possible defense is that there is a four year statute of limitations on a civil RICO cause of action[49] and a five year statute of limitations on a criminal RICO cause of action.[50]

B. Mail and Wire Fraud

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[42] 18 U.S.C. § 1961.
[43] 18 U.S.C. § 1961.
[44] 18 U.S.C. § 1964 (a).
[45] 18 U.S.C. § 1964 (c).
[46] Congress adopted the state crimes as predicate acts without adopting state procedure. *See* United States v. Davis, 576 F.2d 1065 (3rd Cir. 1978), *cert. denied*, 439 U.S. 836 (1979).
[47] Schact v. Brown, 711 F.2d 1343 (7th Cir. 1983), *cert. denied* 464 U.S. 1002 (1983), *later proceeding* 831 F.2d 149 (7th Cir. 1987); Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982), *cert. denied* 103 S. Ct. 177 (1982).
[48] Thillens v. Community Currency Exchange Association, 729 F.2d 1128 (7th Cir. 1984), *cert. denied* 469 U.S. 976 (1985).
[49] Agency Holding Corp. v. Malley-Duff & Associates, 483 U.S. 143 (1987).
[50] 18 U.S.C. § 3282.

18 U.S.C. sections 1341 and 1343 deal with the commission of fraud by using the mails, wire, radio, or television. They are essentially the same except for the means used to carry out the fraud and are broadly written to deal with ever changing schemes to defraud the public. Section 1341 reads as follows:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme for artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail or such carrier according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined under this title or imprisoned not more than five years, or both. If the violation affects a financial institution, such person shall be fined not more than $1,000,000 or imprisoned not more than 30 years or both.[51]

The elements for mail and wire fraud are quite simply that:

(1) the defendant knowingly and willingly participated in a scheme or artifice to defraud with specific intent to defraud and

(2) that the defendant used the mails or some interstate wire communications to accomplish the scheme or artifice.[52]

The penalties are fines and imprisonment for up to 30 years, or both. Good faith[53] is a complete defense to a charge of mail or wire fraud in that it negates the intent necessary to prove fraud.[54]

C. Fraudulent Statements

18 U.S.C. section 1001(a) provides that:

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[51] 18 U.S.C. § 1341. Section 1343 reads much the same except for that the means to defraud are “wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures or sounds...”. See generally Laura A. Eilers and Harvey B. Silikovitz “Mail and Wire Fraud” 31 Am. Crim. L. Rev. 703 (1994).

[52] United States v. Sawyer, 85 F.3d 713 723 (1st Cir. 1996).

[53] See United States v. Preston, 634 F.2d 1285, 1294 (10th Cir. 1980), *cert. denied,* 469 U.S. 976 (1982) (“Good faith” is a genuine belief that the information is true.).

[54] United States v. Dunn, 961 F.2d 648,650 (7th Cir. 1992).

> Except as otherwise provided in this section, whoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States , knowingly and willfully--(1) falsifies, conceals, or covers up by any trick scheme or device a material fact; (2) makes any materially false, fictitious, or fraudulent statement or representation; or (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious or fraudulent statement or entry shall be fined under this title or imprisoned not more than five years, or both.[55]

The elements for this crime are:

(1) a statement,

(2) the falsity of that statement,

(3) the materiality of that statement,

(4) the specific intent to defraud, and

(5) agency jurisdiction over the matter of the statement.[56]

The penalty for violations is fines and imprisonment up to five years. The first defense is the defense of literal truth. This is usually a question of the specific language used in a reply to a government agent and what it means to both parties involved.[57] The second defense involves the materiality of the statement. The test for materiality is whether the falsification had a natural tendency to influence or was capable of influencing the determination of an agency of the Government.[58] The courts are split as to whether the question of materiality is a question for the judge or for the jury.[59] A third possible defense in a section 1001 prosecution is the judicially created doctrine of "exculpatory no".[60] This doctrine creates an exemption from prosecution[61] for negative exculpatory responses to investigators.[62] It is based on the rationale that a person is under no obligation to assist criminal investigators in establishing his or her guilt,[63] the same rationale that informed the Fifth Amendment to the U.S. Constitution.[64]

D. Other Federal Statutes Concerning False Claims Against the Government

There are three other statutes that concern false claims against the government. 31 U.S.C. section 3729 and 41 U.S.C. section 604 provide for civil penalties while 18 U.S.C. section 287 provides for criminal penalties. Careful review and consideration of these sections are important

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55 18 U.S.C. 1001(a). See generally Jennifer L. Kraft and David A. Sadoff "False Statements" 31 Am. Crim L. Rev. 539 (1994).

56 United States v. Herring, 916 F.2d 1543 (11th Cir. 1990), *cert. denied,* 500 U.S. 946 (1991).

57 United States v. Milton, 8 F.3d 39 (4th Cir. 1993), *cert. denied,* 513 U.S. 919 (1994) (question as to the meaning of the word "claim").

58 United States v. Parsons, 967 F.2d 452 (10th Cir. 1992).

59 United States v. Bullock, 857 F.2d 367 (7th Cir. 1988) (Materiality is a question of law for a judge to decide;) *but see* United States v. Gaudin, 28 F.3d 943 (9th Cir. 1994), *aff'd,* 515 U.S. 506 (1995) (materiality is a mixed question of fact and law and is for the jury to determine.).

60 United States v. Myers, 878 F.2d 1142, 1143-44 (9th Cir. 1989)

61 Subsection (b) exempts statements and other representations made in a judicial proceeding. 18 U.S.C. § 1001(b).

62 United States v. Barr, 963 F.2d 641, 645 (3rd Cir. 1992).

63 United States v. Cogdell, 844 F.2d 179, 185 (4th Cir. 1988).

64 United States v. Lambert, 501 F.2d 943, 946 n. 4 (5th Cir. 1974) (noting the territory shared by the "exculpatory no" doctrine and the Fifth Amendment.).

if your principal's plans for mitigating possible losses hinge on the assertion of claims against the government.

31 U.S.C. section 3729, commonly known as the False Claims Act, sets out the elements for the imposition of civil penalties for knowing presentation of false claims. It provides:

> Any person who-
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> (1) knowingly presents, or causes to be presented, to an officer or employee of the United States Government or a member of the Armed Forces of the United States a false or fraudulent claim for payment or approval;[65]
>
> (2) knowingly makes, uses, or causes to be made or used, a false record or statement to get a false or fraudulent claim paid or approved by the Government.
>
> (3) conspires to defraud the Government by getting a false or fraudulent claim allowed or paid;
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> * * * *
>
> is liable to the United States Government for a civil penalty of not less than $5,000 and not more than $10,000, plus 3 times the amount of damages which the Government sustains because of the act of that person, except that if the court finds that --
>
> (A) the person committing the violation of this subsection furnished officials of the United States responsible for investigating false claims violations with all information known to such person about the violation within 30 days after the date on which the defendant first obtained the information;
>
> (B) such person fully cooperated with any Government investigation of such violation; and
>
> (C) at the time such person furnished the United States with the information about the violation, no criminal prosecution, civil action, or administrative action had commenced under this title with respect to such violation, and the person did not have actual knowledge of the existence of an investigation into such violation;
>
> the court may assess not less than 2 times the amount of damages which the Government sustains because of the act of the person. A person violating this subsection shall also be liable to the United

65 31 U.S.C. § 3729. See generally John R. Phillips "False Claims Act in Practice", 14 L.A. Law. 30 (1991).

States Government for the costs of a civil action brought to recover any such penalty or damages.

(b) Knowing and knowingly defined. - For purposes of this section, the terms “knowing” and “knowingly” mean that a person, with respect to information -

(1) has actual knowledge of the information;

(2) acts in deliberate ignorance of the truth or falsity of the information; or

(3) acts in reckless disregard of the truth or falsity of the information,

and no proof of specific intent to defraud is required.

(c) Claim defined - For purposes of this section, “claim” includes any request or demand, whether under a contract or otherwise, for money or property which is made to a contractor, grantee, or other recipient if the United States Government provides any portion of the money or property which is requested or demanded, or if the Government will reimburse such contractor, grantee, or other recipient for any portion of the money or property which is requested or demanded.

18 U.S.C. section 287 is the criminal law counterpart to the False Statements Act. It provides that:

> Whoever makes or presents to any person or officer in the civil, military, or naval service of the United States, or to any agency or department thereof, any claim upon or against the United States, or any department or agency thereof, knowing such claim to be false, fictitious or fraudulent, shall be imprisoned not more than five years and shall be subject to a fine in the amount provided in this title.[66]

41 U.S.C. section 604, part of the Contract Disputes Act, also punishes false or fraudulent claims. It provides:

> If a contractor is unable to support any part of his claim and it is determined that such inability is attributable to misrepresentation of fact or fraud on the part of the contractor, he shall be liable to the

66 18 U.S.C. § 287.

> Government for an amount equal to such unsupported part of the claim in addition to all costs to the Government attributable to the cost of reviewing said part of his claim. Liability under this subsection shall be determined within six years of the commission of such misrepresentation of fact or fraud.[67]

IV. CONCLUSION

Statutes such as the UFTA and federal RICO and fraud statutes are broadly written to allow for flexible application to varying factual patterns. It is this flexibility that allows creditors and/or prosecutors to use these statutes as powerful tools to either obtain money damages or to punish fraudulent behavior. Because of the breadth of these statutes, a surety professional analyzing a proposal from the principal to mitigate possible losses should be aware that the principal's proposal could possibly involve actions within the coverage of one or more of these statutes. By looking at the proposal from a party that may want to attack the transaction or seek recovery from the surety and knowing the weapons available to such party, the surety professional can better gauge the risks associated with the principal's proposal for mitigating losses.

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[67] 41 U.S.C. § 604. For an excellent discussion of the surety's pursuit of the principal's contract claims end the applicable procedures, see Patrick J. O'Connor, Jr. "The Principal's Contract Claims a Salvage - A Primer" in Salvage by the Surety (George J. Bachrach ed. ABA 1998).

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