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FALSE FINANCIAL STATEMENTS AS THE BASIS FOR NONDISCHARGEABLE DEBTS:

IDENTIFYING THE BAD GUYS AND MAKING THEM PAY

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Table of Contents

I. INTRODUCTION..3

A. The Surety – Principal Relationship……………………………………………3

II. PROVIDING FALSE FINANCIAL STATEMENTS CREATES NONDISCHARGEABLE DEBTS……………………...…………………….…... 4

A. A Typical Scenario (*In re Adams*)…………………………………………………4

B. Statements Must be in Writing…………………………….……………………5

C. Statements Must be Materially False……………………….……………………..6

D. The Statement Regards the Debtor's Financial Condition……..………………..6

E. The Debtor Caused the Statement to be Made or Published………………….7

F. The Debtor Had the Intent to Deceive……………………………………………7

G. The Creditor Reasonably Relied Upon the Debtor's Statement……………….8

III. TYPES OF FINANCIAL STATEMENTS PROVIDED BY PRINCIPALS TO SURETIES AND COMMON METHODS OF FALSIFICATION…………………..……………9

A. Contingent Liabilities…………………………………………………….……… 9

B. Off-Book Liabilities………………………………………………….………… 11

C. Cash Assets Inflated Due to Check Kiting………………………….……… 13

D. Acquiring Short-Term Loans to Increase Assets……………………………. 13

IV. IDENTIFICATION OF OTHER BAD GUYS AND HOW TO MAKE THEM PAY….. 14

A. Who Are the Other Bad Guys?……….…………………………...……...……… 14

B. A Typical Scenario (*Leahey Construction*)……….……………………........…… 15

C. Theories of Liability……….………………………….………………..………..16

D. Are Judgments Against the Bad Guys Dischargeable?………..…...………....19

V. CONCLUSION……………………….…………………………….…………….... 20

False Financial Statements as a Basis for a Nondischargeable Debt: Identifying the Bad Guys and Making Them Pay

I. INTRODUCTION

For a debtor, the purpose of the United States Bankruptcy Code is to provide him with a "fresh start." When filing for bankruptcy, this fresh start takes the form of a discharge of debts the debtor owes creditors. However, the United States Supreme Court has declared the fresh start provided by the Bankruptcy Code is only for the "honest and unfortunate" debtor.[1] The code provides exceptions, outlining situations where a debtor is not acting honestly. One such situation is where a debtor provides a creditor false financial statements upon which the creditor relies.[2] In such situations, the creditor retains the right to seek recovery from the debtor.

Because ordinary debts owed a surety under the principles of equitable subrogation and/or contractual indemnity may be discharged in bankruptcy, huge losses may justify the exercise of other non-traditional remedies which may not be avoidable in bankruptcy. The purpose of this paper is to inform the reader of nondischargeable remedies a surety potentially maintains against its principal, the principal's owners, officers, and directors, and those who assist the principal in defrauding the surety. Please note that this paper does not substitute for legal advice and the reader is cautioned to consult with their counsel before acting in accordance with any information contained herein.

A. The Surety – Principal Relationship

Sureties typically require an array of financial information prior to entering agreements to provide bonds to principals. This financial information takes the form of applications, performance track records, credit reports, tax records and audited financial statements. These documents are typically reviewed by a bonding agent and submitted to the surety's underwriters, who establish a bonding limit for the principal. Often times, in addition to the bonding agent and the principal's owners, officers, and directors, the assistance of accountants, bankers and lawyers is required to present the principal's condition to the surety. Once the underwriting phase is completed, the surety-principal ("bonding") relationship is established by means of a master surety agreement or general indemnity agreement. These agreements, however denominated, describe the party's relationship.

The surety-principal relationship usually requires that the principal continuously keep the surety informed as to the principal's financial state. This is often done through the use of an audited financial statement, annually performed, whereby the principal or agent thereof, and/or its attorney, provides financial information to the surety regarding the principal's assets, liabilities, contingent liabilities, and owner equity.

While measures such as indemnity provisions and reliance upon extensive and continuous financial information decreases a surety's exposure to liability, a principal or individual indemnitor who declares bankruptcy does so with the intent of relieving himself from <u>all</u> debts. This includes indemnification to the surety. However, the Bankruptcy Code has

[1] *Grogan v. Garner*, 498 U.S. 279, 287 (1991).
[2] 11 U.S.C.A. §523(a).

provided a means by which sureties can continue to pursue their debts against principals, and/or the owners, officers, and directors of a principal, provided the principal furnished false financial statements to secure bonding from the surety.

II. PROVIDING FALSE FINANCIAL STATEMENTS CREATES NONDISCHARGEABLE DEBTS

The fresh start mentioned above is provided by Bankruptcy Code Section 727.[3] It states that "[t]he court should grant the debtor a discharge, unless . . . ."[4] The code goes on to list nine grounds in which a court should deny a debtor's request for discharge.[5] The third such ground is when "the debtor has . . . falsified . . . any recorded information . . . from which the debtor's financial condition or business transactions might be ascertained . . . ."[6] Therefore, a court should deny a bankruptcy debtor's request for discharge of debts when the debtor has provided false financial statements.

While Section 727 provides the general grounds for a court's denial of discharge, Section 523 goes a step further and expressly provides exceptions to when a debt may be discharged. One such exception is for providing false statements of a debtor's financial condition. Section 523 states:

> (a) A discharge under section 727 . . . of this title does not discharge an individual debtor from any debt . . .
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . .
>
> (B) use of a statement in writing—(i) that is materially false; (ii) respecting the debtor's or an insider's financial condition; (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and (iv) that the debtor caused to be made or published with intent to deceive.[7]

If the above elements are satisfied, the debt is nondischargeable. However, the burden is on the creditor or surety (plaintiff) to prove that these requirements were satisfied.[8]

A. A Typical Scenario (*In re Adams*)

Mr. Adams was the managing member, an officer, and employee of Summit Companies, L.L.C. ("Summit").[9] Mr. Adams, on behalf of Summit, entered into a contract with the State of North Carolina to perform construction work at the North Carolina School of the

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[3] *See* 11 U.S.C.A. §727(a).
[4] *Id.*
[5] *Id.*
[6] *Id.* at §727(a)(3).
[7] 11 U.S.C.A. §523(a)(2)(B).
[8] *See In re Black*, 787 F.2d 503 (10th Cir. 1986)(reversed on other grounds by *Grogan v. Gardner*, 498 U.S. 279 (1991)).
[9] *In re Adams*, 312 B.R. 576, 579 (Bankr. M.D.N.C. 2004)(mem.).

Arts.[10] This contract required Summit to provide payment and performance bonds for the project.[11] In order to obtain the required bonds, Summit provided financial information, including an application questionnaire, contractor's qualification statement, biography of Mr. Adams, three letters of recommendation, a bank statement, and the company's balance sheet, to Cumberland Surety Insurance ("Cumberland").[12] After reviewing and relying on the financial information, Mr. Helmbrecht, a bonding agent for Cumberland, issued the payment and performance bonds to Summit for the school project with a face amount of $3,121,341.00.[13] Before the project was complete, Summit abandoned the project stating it was financially unable to complete the project.[14] Cumberland was then required under its bonds to complete the project and pay the claimants a total cost of $1,593,544.01.[15] Cumberland sued Mr. Adams to have the losses resulting from Summit's default declared nondischargeable so it might recover such losses under their indemnity agreement.[16] The court applied 11 U.S.C.A. §523(a)(2)(B), finding that the debt was nondischargeable, and held Mr. Adams personally liable, as the managing member and officer of Summit, to Cumberland for the entire amount.[17]

B. Statements Must be in Writing

For a debt to meet the false financial statement discharge exception, the statements of financial condition the debtor makes to a creditor must be in writing.[18] Oral statements relating to financial condition are not sufficient to deem the debt nondischargeable.[19] In *Engler v. Van Steinburg*, a debtor obtained a loan for $5,500.00 from a creditor in exchange for a security interest in the debtor's livestock and farm equipment.[20] The debtor made oral representations to the creditor that his property was free and clear from encumbrances.[21] When the debtor defaulted, the creditor asked the court to declare the debt nondischargeable.[22] The court held, "[t]he Bankruptcy Act provides that . . . false statements 'respecting the debtor's . . . financial condition must be in writing in order for the debt to be nondischargeable."[23]

In *Adams*, the court found the element that the statement is in writing was satisfied by the financial statements Adams provided (responses to questionnaires, bank statements, and balance sheets) to Cumberland.[24] Therefore, the court held that the first element was satisfied.

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[10] *Id.*
[11] *Id.* at 580.
[12] *Id.* at 580-82.
[13] *Id.* at 580.
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.* at 587.
[18] 11 U.S.C.A. §523(a)(2)(B).
[19] *Engler v. Van Steinburg*, 744 F.2d 1060 (4th Cir. 1984)(oral statement that property was not subject to liens was insufficient to make debt nondischargeable).
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Adams*, 312 B.R. at 582.

C. Statements Must be Materially False

For a debt to be nondischargeable, the financial statements made by the debtor to the creditor regarding the debtor's financial condition must be materially false.[25] This element holds that the representation by the debtor: 1) be a fact, and 2) be material to the transaction. The requirement that the falsity be a fact includes an omission of relevant facts when providing statements of financial condition.[26] In *Adams*, the court found that Mr. Adams failed to include in his financial statements information regarding six liens and lawsuits pending against Summit, that there were three projects Summit was struggling to complete, and that there was approximately $800,000.00 of liabilities outstanding.[27] These are examples of omissions of relevant facts meeting the factual requirement.

In addition to being a statement of fact or omission of relevant facts, the statement must be materially false.[28] Again in *Adams*, the court found that the statements prepared by Dixon Odom, P.L.L.C. (Adam's accountant) were prepared from information Mr. Adam's provided and overstated Summit's working capital by more than $400,000.00.[29] The court held this overstatement, along with the omitted financial information, was sufficient to meet the materially false element.[30]

D. The Statement Regards the Debtor's or an Insider's Financial Condition

The false written statements provided by the debtor must regard the debtor's or an insider's financial condition.[31] These statements must reflect financial information about the debtor in an attempt to obtain "money, property, services, or an extension, renewal, or refinancing of credit."[32] These statements extend to insiders who are typically thought of as persons or entities which are in a position to influence the debtor's financial actions and decisions. Insiders include relatives of the debtor, general partners of the debtor, and any corporation of which the debtor is a director, officer, or "person in control."[33] Therefore, if an insider furnishes false written statements of a corporation's financial condition, or hides assets, and that statement was used to obtain money, property, services, or credit, the debt for which the statements were made would not likely be found by a bankruptcy court to be dischargeable.

In *Adams*, the court held that Summit was an insider of Mr. Adams since it was a corporation of which Mr. Adams was an officer and "person in control" of the financial documents when they were submitted to Cumberland.[34] Therefore, the statements provided from Mr. Adams to Cumberland regarded an insider's financial condition meeting the third element.

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[25] 11 U.S.C.A. §523(a)(2)(B).
[26] *Beneficial Nat'l Bank v. Priestley (In re Priestley)*, 201 B.R. 875 (Bankr. D.C. Del. 1996).
[27] *Adams*, 312 B.R. at 583.
[28] 11 U.S.C.A. §523(a)(2)(B).
[29] *Adams*, 312 B.R. at 583.
[30] *Id.*
[31] 11 U.S.C.A. §523(a)(2)(B).
[32] *Id.*
[33] 11 U.S.C.A. §101(31)(A).
[34] *Adams*, 312 B.R. at 582.

E. The Debtor Caused the Statement to be Made or Published

The debtor must cause the statements to be made or published for them to bar the discharge of a debt.[35] This element is not satisfied when the debtor can show that he relied upon someone else to make or prepare the financial statements and had no knowledge or understanding of its falsity. The most common context this defense appears is when a spouse seeks discharge of debt. For example, in *Adams*, Cumberland filed suit against Mr. Adams and Ms. Adams since she was member of Summit.[36] However, the court found that Ms. Adams "was not involved in the day-to-day operations of Summit . . . there was no evidence she had any communications or involvement of any kind with Cumberland . . . [and] there was no evidence she had any knowledge of or participation in preparing the fraudulent documents."[37] Therefore, the court found she was not liable for the debt in any way.[38]

However, this element has been satisfied when the debtor provides the information from which the statement of financial condition is made or when the debtor has adopted the financial statement as his own.[39] In *Adams*, the court found that the financial statements were a compilation prepared by Summit's accountants.[40] However, the court found that the statement "was prepared from information which Mr. Adams caused to be supplied to [the accountant] . . . and the statement was represented by Mr. Adams as being the latest balance sheet available."[41] Therefore, the court found that while Ms. Adams was not liable because she had no knowledge, Mr. Adams was liable because he caused the statements to be made and published.[42]

F. The Debtor Had the Intent to Deceive

The debtor must have intended to deceive the creditor through the statements of financial condition the debtor provides to the creditor.[43] The standard by which the debtor's intent is determined is under the "totality of the circumstances."[44] The court in *Adams* stated "because it is nearly impossible to obtain direct proof of a debtor's state of mind, a creditor may present evidence of the surrounding circumstances from which such intent may be inferred."[45] In that case, the court found that the circumstances showed that Mr. Adams managed the day-to-day business of Summit, was intimately familiar with the business records and operations, and had many years of experience in obtaining bonds from bonding companies.[46] Thus, the court inferred that Mr. Adams was aware of the liens and suits against his company, was aware of Summit's payables, and was aware that sureties would rely upon his representations in deciding whether to issue bonds.[47] Therefore, the court inferred Mr. Adam's intent to deceive.

[35] 11 U.S.C.A. §523(a)(2)(B).
[36] *Adams*, 312 B.R. at 579.
[37] *Id.* at 587.
[38] *Id.*
[39] *Enterprise Nat'l Bank v. Jones (In re Jones)*, 197 B.R. 949 (Bankr. M.D. Ga. 1996).
[40] *Adams*, 312 B.R. at 583.
[41] *Id.*
[42] *Id.* at 587-88.
[43] 11 U.S.C.A. §523(a)(2)(B).
[44] *Jones*, 197 B.R. at 949.
[45] *Adams*, 312 B.R. at 586.
[46] *Id.*
[47] *Id.*

G. The Creditor Reasonably Relied Upon the Debtor's Statement

Finally, to prevail in a nondischargeability complaint, the creditor must show that it reasonably relied upon the statements of financial condition provided by the debtor.[48] Unlike the subjective element of a debtor's intent to deceive, this element is objective and has been held by courts to mean that creditors must make reasonable inquiries into the accuracy of the statements provided by debtors if the creditor obtains information that places it "on notice" that a falsity may exist.[49] One court has held that when considering a creditor's reasonable reliance, the court should look at: 1) whether the parties had previous business dealings that gave a rise to a relationship of trust; 2) whether there were any "red flags" that would have alerted an ordinary prudent lender to the possibility of inaccuracies; and 3) whether even minimal investigation would have revealed the inaccuracy of the debtor's statements.[50] In *Adams*, the court found that there were no disclosures or indications that Summit was experiencing financial difficulties, there were no "red flags", and it would have required considerably more than a minimal investigation to discover the falsity of the statements.[51] Therefore, Cumberland reasonably relied upon Summit's financial statements as provide by Mr. Adams.

Ultimately, the court found all elements were satisfied by Cumberland and that the payments made by them in accordance with their bonds as a result of Summit's default were in reliance upon the false documents provided by Mr. Adams.[52] Therefore, the court stated "[s]uch payments and expenses were proximately caused by the fraud of Mr. Adams in submitting materially false documents pertaining to the financial condition of Summit . . . [and] such loss constitutes a debt of Mr. Adams which is nondischargeable pursuant to §523(a)(2)(B) of the Bankruptcy Code."[53] The court found Mr. Adams personally liable to Cumberland because of his actions as corporate officer and agent of Summit.[54]

As discussed in *Adams*, each element of 11 U.S.C.A. §523(a)(2)(B) is separate and distinct. A creditor who seeks to have its debt deemed nondischargeable by a court has the burden of proving each of the above elements by a preponderance of the evidence.[55] Failure to prove even one element could result in a court determining a debt is dischargeable, merely precluding a creditor from ever collecting that debt. Therefore, financial statements are important, not just for determining whether to bond a principal, but in seeking recovery from a defaulting principal or its officers, owners, or directors. For this reason, an understanding of the numerous ways financial statements are manipulated and/or falsified is essential when considering not only the establishment of a bonding relationship, but when challenging a discharge as well.

[48] 11 U.S.C.A. §523(a)(2)(B).
[49] *Citibank v. Eashai (In re Eashai)*, 87 F.3d 1082 (9th Cir. 1996).
[50] *Coston v. Bank of Malvern (In re Coston)*, 991 F.2d 257 (5th Cir. 1993).
[51] *Adams*, 312 B.R. at 585.
[52] *Id.* at 586.
[53] *Id.* at 587.
[54] *Id.*
[55] *See Grogan v. Garner*, 498 U.S. 279, 288 (1991).

III. TYPES OF FINANCIAL STATEMENTS PROVIDED BY PRINCIPALS TO SURETIES AND COMMON METHODS OF FALSIFICATION

The information reviewed by sureties when considering bonding takes many different shapes and forms. Like in *Adams*, where the financial information provided was in the form of questionnaires, qualification statements, letters of recommendation, bank statements, and balance sheets, falsities may exist in any or all of the documents provided. Below are a few ways principals commonly mislead sureties.

A. Contingent Liabilities

Contingent liabilities are obligations, the timing and amount of which are contingent on the occurrence of some uncertain future event. They are therefore not yet liabilities, and may never be if the specific contingency does not materialize.[56] These obligations, although not yet definite, are commonly omitted from statements of financial condition principals provide to sureties.

For example, in *Staten Island Savings Bank v. Scarpinito*, the court found that Scarpinito (as owner of Scarpi Realty Corporation) had provided written statements of his financial condition showing assets of approximately $11 million and liabilities of only $2.2 million when applying for a real estate loan.[57] The court also found that the financial statements provided failed to include contingent liabilities amounting to over $7 million dollars.[58] These contingent liabilities included a personal guarantee of $2 million to Citibank and millions of dollars to other various financial institutions.[59] The court held that "the omission of significant contingent liabilities (i.e. over $7 million or approximately 80% of his reported net equity) would render the financial statements he provided materially false."[60] Ultimately, the court declared Scarpinito's debt to Staten Island Savings Bank was nondischargeable.[61] However, the time and money expended by the bank in litigating the issue of dischargeability may have been avoided had the bank merely inquired further into Scarpinito's contingent liabilities.

Another example of falsifying contingent liabilities includes filed liens or pending lawsuits. In *Adams*, the court found that Mr. Adams failed to reveal at least six pending liens and lawsuits.[62] In fact, Mr. Adams, when specifically asked if any liens or lawsuits were pending, denied that any existed.[63] Fortunately, the surety in *Adams* was able to prove all the elements under 11 U.S.C.A. §523(a)(2)(B) and allowed to pursue its claims against Mr. Adams personally as owner and the person in control. However, the surety was allowed to continue pursuit of its claims because it looked beyond the financial documents to Mr. Adams' express denial of liens and lawsuits to prove his intent to deceive. This is an example of how asking specific questions about filed liens and pending lawsuits and requesting lists of all legal fees

[56] http://www.imf.org/external/np/fad/trans/manual/gloss.htm (International Monetary Fund Web Site).
[57] *Staten Island Sav. Bank v. Scarpinito*, 196 B.R. 257, 262 (Bankr. E.D.N.Y. 1996).
[58] *Id.* at 262-63.
[59] *Id.* at 262.
[60] *Id.* at 263 (citing *In re Bebar*, 315 F.Supp. 841, 845 (E.D.N.Y. 1970)).
[61] *Id.* at 268.
[62] *Adams*, 312 B.R. at 583.
[63] *Id.*

paid to detect pending litigation may keep the door of recovery open for sureties who ask the court to declare a principal's debt nondischargeable.

a. Audit Inquiry Response Letters

One way sureties monitor the financial state of a principal is by requiring annual audited financial statements. Typically, auditors request various types of information from the principal, and/or the principal's representative, when preparing financial audits. The requests include information about pending liens and lawsuits, recent judgments rendered, the principal's assets, liabilities, contingent liabilities, and owner equity. One of the items commonly requested from the principal's counsel is a letter describing pending litigation contingencies.

Lawyers usually respond to audit inquiries with an audit response letter. The American Bar Association ("ABA") has assembled a Statement of Policy regarding what is and is not proper with regards to the lawyer's response. In that policy, the ABA states:

> Unless the lawyer's response indicates otherwise, (a) it is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation . . . [w]hen properly requested by the client, it is appropriate for the lawyer to furnish the auditor information concerning the following matters . . . (a) overtly threatened or pending litigation, whether or not specified by the client . . .
>
> [In addition] the lawyer should normally refrain from expressing judgments as to the outcome except in those relatively few cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote" . . .
>
> The lawyer has an obligation to not knowingly participate in any violation by the client of the disclosure requirements of the securities laws . . . .[64]

If the lawyer has an obligation imposed by the client to respond to the auditor, he should be careful to respond diligently and accurately in accordance with the above guidelines. While any response to the auditor's request for information will not subject an attorney to liability[65], it may be considered as part of the circumstances surrounding a claim against an attorney for any of the theories of liability discussed below. Therefore, auditor's response letters are another method that may be used to falsify a principal's financial condition.

Ultimately, not even an audited financial statement guarantees that all contingent liabilities are included therein. A determined principal may conceal these potential liabilities to make their financials look more balanced when applying for bonding. For this reason, it is important to require information regarding contingent liabilities and review all such information to ensure no "red flags" are present. While this is the responsibility of the auditor, it is good

[64] American Bar Association: Statement of Policy Regarding Lawyers' Responses to Auditors' Request for Information 5-9 (1990).

[65] ***Tew v. Arky, Freed, Stearns, Watson, Greer, Weaver & Harris, P.A.*, 655 F.Supp. 1573 (S.D. Fla. 1987).**

practice for sureties to request additional information from principals and auditors when transactions are recent and substantially affect the principal's asset to liability ratio. In addition, requiring lists of legal fees and expenses will help provide insight into potential pending litigation not reported.

B. Off-Book Liabilities

Liabilities are debts or obligations already owed to others. They are not contingent upon a separate future event occurring. One form of falsifying financial statements is to omit liabilities from financial documents, or to keep them "off the books." The effect of doing such is the assets are not offset by the liabilities, merely creating an inflated capital appearance. This makes a company seem more self-funded and profitable while appearing less debt dependant. When liabilities are left off the books, sureties are unable to asses the true financial condition of the principal and may extend bonding to a company likely to default.

For example, in *Genesco v. Redford*, Mr. Redford (as owner of Redford's Fashion Shoes) sent a balance sheet to Genesco, Incorporated in an attempt to obtain a line of credit with Genesco to supply shoes.[66] The statement showed that Mr. Redford had liabilities of $360.22 and total assets of $25,511.48.[67] Relying on this balance sheet, Genesco began supplying shoes to Redford.[68] After the first shipment of shoes, Redford called Genesco and informed it that he had misstated the liabilities by failing to include a $27,100.00 liability owed to a bank and more than $6,000 in accounts payable.[69] Even with this information, Genesco continued to provide shoes.[70] Finally, Redford sought bankruptcy and Genesco moved to have the debt excepted from discharge.[71] The court held that misstating the liabilities "in the neighborhood of $33,000.00 was so substantial there could be no question of material falsity" of the statement, but the fact that Genesco continued to provide shoes proved no reliance on the statement and the debt was discharged.[72]

Manipulating, failing to include, or mischaracterizing accounts payable is another method of keeping liabilities off the books. For example, in *Bud Antle, Inc. v. Elliot*, a creditor sought exception to discharge for a line of credit it extended to Elliot (former owner and operator of Emerson Elliot Produce Co.) as a result of the financial statements Elliot provided.[73] The court found that the financial statements Elliot provided showed $285,000.00 in accounts receivable as opposed to the actual $253,000.00 in accounts payable.[74] This mischaracterization led the creditor to provide Elliot with a line of credit.[75] The court found that Bud Antle had proven all the elements for the exception and granted the exception to discharge for the debt, holding Elliot personally liable as the company's owner.[76]

These examples of manipulating, failing to include, and mischaracterizing liabilities are

[66] *Genesco, Inc. v. Redford (In re Redford)*, 7 B.R. 322, 324 (Bankr. M.D. Ga. 1980).
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *Id.* at 324-25.
[73] *Bud Antle, Inc. v. Elliot*, 93 B.R. 776, 777 (Bankr. M.D. Fla. 1988).
[74] *Id.*
[75] *Id.*
[76] *Id.* at 778.

some ways a principal, or its owners, officers, and directors, may alter the liabilities owed in order to receive credit or bonding. While detecting such discrepancies is often very difficult, and should be caught by the auditor, that is not always the case. The surety's reliance upon the auditor's report is paramount to protecting the surety and therefore, sureties should research the auditor's background to ensure the auditor's diligence and reliability. If the principal has selected an auditor not known to the surety, inquiring about the auditor's client lists, services performed for the principal, and length of relationship between the auditor and principal will provide the surety insight as to the trustworthiness and reliability of the auditor's financial report.

a. Tax Records

Another method to detect potential liability misrepresentations, manipulations, and/or mischaracterizations is to require the principal to provide copies of its tax records and returns. While failure of a creditor or surety to require and review the tax returns is not required to meet the reasonable reliance element under 11 U.S.C.A. §523(a)(2)(B)[77], it is a prudent way to ensure that a principal is consistent with the financial information he is providing to the surety on the one hand, and to the government on the other. Often times, a principal provides a financial statement that says one thing in order to obtain bonding or credit and then revises that statement before filing its taxes. Failure to obtain such information may prove detrimental to the underwriting surety.

For example, in *Citizens Bank of Washington County v. Wright*, Wright, on behalf of Milestone Mobile Homes, Incorporated ("Milestone") of which he was a shareholder, officer, and director, entered into a floor-plan financing agreement with Citizens Bank ("Citizens").[78] The terms of this agreement required that Wright provide a statement of Milestone's financial condition each year to renew the financing agreement.[79] Between 1995 and 1999, Wright provided Citizens with financial statements to renew his financing agreement that would show assets, profits, revenues, and equity inflated thousands of dollars more than shown on Milestone's tax returns.[80] Finally, Milestone defaulted and sought bankruptcy relief in 2001.[81] Citizens filed a complaint to have the outstanding debts owed them by Milestone, and Wright individually, declared nondischargeable because the financial statements provided to them each year were materially false.[82] While Citizens was successful in its suit and Wright was held personally liable as an officer and director, the time and expense of the litigation could have been avoided had Citizens required a copy of Milestone's tax return each year to verify the company's financial condition.

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[77] *Bomis v. Nat'l Fire Ins. Co.*, 25 F.3d 1047 (6th Cir. 1994)(Circuit Court upheld the District Court's refusal to deem unreasonable National Union's failure to request Bomis's tax returns).
[78] *Citizens Bank of Washington County v. Wright (In re Wright)*, 299 B.R. 648, 652 (Bankr. M.D. Ga. 2003).
[79] *Id.* at 653.
[80] *Id.*
[81] *Id.* at 656.
[82] *Id.* at 658.

C. Cash Assets Inflated Due to Check Kiting

Check Kiting is the activity of drawing checks on an account in one bank and depositing them in a second bank when neither bank has sufficient funds.[83] Then, just before the check is sent to the first bank for payment, a check is drawn from the second account and placed into the first to cover the original check.[84] Because the "float time" in the transfer of money between banks, this creates an artificial balance, or what is in essence an undocumented loan, in the second account.[85] Principals can use this scheme to create artificial accounts which inflate their cash position. Principals then declare this inflated cash position on their financial statements to make their company appear to be a lower financial risk. This has been held by many courts to be fraud and is a grounds to declare a debt nondischargeable.

While no cases address a debtor attempting to obtain bonding with inflated financial statements due to check kiting, many cases do find check kiting is fraudulent within the bounds of 11 U.S.C.A. §523(a)(2)(A).[86] This part of the code excepts debts from discharge for "false pretenses, a false representation, or actual fraud . . . ."[87] Therefore, because the willingness of courts to find check kiting fraudulent, it is likely a court will find financial statements inflated by check fraud as false statements in violation of 11 U.S.C.A. §523(a)(2)(B).

To prevent from bonding a company with inflated cash on hand due to check kiting, a good practice is to request a summary list of all payments the principal has made to financial institutions and statements from each financial institution showing all transactions pertaining to all accounts. A principal's use of numerous accounts at numerous banks is one signal that a potential check kiting situation exists. In addition, should large transactions or deposits appear that substantially inflate the account balance, it would be prudent to wait until the transaction has cleared the bank of origin before issuing bonds to insure the funds are adequate and real.

D. Acquiring Short-Term Loans to Increase Assets

Another way principals falsify their financial condition is by obtaining short-term loans to bolster the assets of a principal long enough to acquire bonding. After the surety, relying upon the financial statements showing the bolstered assets, provides bonding, the principal repays the short-term loans, thus depleting its assets. Failure to detect this inflated asset situation can result in underwriting bonds for an insolvent principal.

In *Aetna Casualty and Surety Company v. Leahey Construction Company*, discussed further below, a construction company (principal) sought a short-term loan from a bank to inflate the principal's assets.[88] The short-term loan was acquired by the principal on a Monday and repaid on the following Friday.[89] A financial audit was taken during the week the loan was outstanding showing the $275,000.00 loan, but not reporting it as a liability, thus inflating the

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[83] *Mellon Bank v. Vitanovich (In re Vitanovich)*, 259 B.R. 873, 877 (6th Cir. 2001).
[84] *Id.*
[85] *Id.*
[86] *Id.* at 879; *In re Halpern*, 810 F.2d 1061 (11th Cir. 1987); *In re Adams*, 31 F.3d 389 (6th Cir. 1994).
[87] 11 U.S.C.A. §523(a)(2)(A).
[88] *Aetna Cas. and Surety Co. v. Leahey Constr. Co., Inc.*, 22 F.Supp.2d 695, 699 (N.D. Ohio 1998)(reversed in part and remanded, 219 F.3d 519 (6th Cir. 2000)).
[89] *Id.*

principal's assets.[90] The surety, relying upon the inflated assets reported in the financial audit, provided bonding to the principal.[91] Although the bonding agent did discover that the short-term loan had been disbursed to the principal on Monday, the agent relied upon statements from Elmore (the principal's outside accountant), without inquiring further, that the loan was from Patrick Leahey personally, not a bank.[92] Months later, the principal defaulted on numerous projects leaving the surety to answer for the principal's debts and incurring losses of more than $2.5 million.[93] This case shows how a surety's reliance upon a financial audit, and its failure to inquire about the principal's recent inflation in assets, caused the surety to suffer huge losses.

In order to avoid situations such as that in the *Leahey Construction* case, sureties should not merely rely upon the statements of the auditing accountant. Sureties should inquire into any transactions that substantially inflate the principal's cash position and seek the source of such loans. In addition, requiring a summary list of all payments to financial institutions will help detect unspecified and outstanding loans.

The risks associated with each of the above documents or methods of falsifying financial statements may be reduced with careful review of documents and requesting additional documentation regarding suspicious transactions. In addition, because of the reliance a surety places on the financial reports prepared by the auditing accountant, a thorough review of the auditor's credentials and relationship with the principal is vital to ensure accuracy in reporting. If the principal is the auditor's largest client or if the auditor also provides, in addition to the audit, tax planning and/or consulting services, it is prudent to cautiously review the audit and inquire into any suspicious statements as there may exist a conflict of interest. A review of the proportionality of the auditor's fee to the principal's revenues may be one way to verify the auditor is not providing a minimum effort to keep its client happy while providing other services.

The costs spent on carefully and thoroughly obtaining and thoroughly reviewing financial documents and audits will likely be less than the losses associated with and the costs spent on litigating such debt related matters. However, regardless of how careful and thorough a surety acts, there still may arise situations where litigation to recover losses is the only possible remedy. In such situations, like in *Leahey Construction*, there may be opportunities to look beyond the principal, its owners, officers, and directors, to other "bad guys" for compensation.

IV. IDENTIFICATION OF OTHER BAD GUYS AND HOW TO MAKE THEM PAY

A. Who Are the Other Bad Guys?

When applying §523(a)(2)(B) of the Bankruptcy Code, it is often possible to obtain relief for the false financial statements against other individuals who assisted in preparation of the documents. Parties who assist in the preparation of financial documents include accountants, bankers, lawyers, and bonding agents. Because of their assistance in preparing financial documents, these parties, in addition to the principal, its owners, officers, and directors, may

[90] *Id.*
[91] *Id.*
[92] *Leahey Construction*, 22 F.Supp.2d at 699.
[93] *Aetna Cas. and Surety Co. v. Leahey Constr. Co., Inc.*, 219 F.3d 519, 524 (6th Cir. 2000).

be found liable in circumstances where false financial documents were provided to the detriment of the surety. Below are a few of the various theories of liability that courts have used to hold parties liable for their assistance in providing false financial documents. In addition, a judgment acquired against these parties may also be declared nondischargeable because of the fraud element present in each of these theories. Therefore, looking beyond the principal, to these other bad guys, may be an alternative ground for a surety's recovery of losses due to reliance upon false financial statements.

B. Typical Scenario (*Leahey Construction)*

In *Aetna Casualty and Surety Company v. Leahey Construction Company*, the surety that provided bonding for Leahey Construction Company ("Leahey") on defaulted construction projects sued Leahey and its bank, banker, accountant, and accountant's firm, asserting various claims arising from alleged misrepresentations about Leahey's financial condition in connection with issuance of surety bonds.[94] In this case, Leahey was a construction company focusing much of its attention in 1996 on public construction projects.[95] Because public entities typically require its construction projects be bonded by a surety to guarantee performance, Leahey, at the recommendation of his insurance provider Mr. Black, contacted Travelers seeking bonding.[96] Travelers requested various financial information from Leahey, reviewed it, and declared that Leahey needed to increase its assets before Travelers would agree to provide bonding.[97] However, Travelers stated that the increase in assets could not be the result of Leahey obtaining a loan, or incurring additional liabilities.[98] Notwithstanding this requirement, Leahey took out a four-day loan for $275,000.000 from Mr. Donnelly at KeyBank to increase his assets long enough to acquire bonding from Travelers.[99] Mr. Donnelly was found by the court to have known of Leahey's intentions in obtaining the short-term loan.[100] Months later a second loan in the amount of $150,000 was obtained through Mr. Donnelly at KeyBank to meet the increased asset request of Travelers.[101]

Leahey also hired Elmore (outside accountant) and Ranallo (inside accountant) to prepare, among other things, his financial statements and balance sheets.[102] The court found that Ranallo "knowingly misstated certain balances . . . including overstating the long-term notes payable by $425,000.00" in order to cover the assets Leahey was supposed to have in the bank, but were actually the short-term loans that Leahey had already paid back.[103] When asked, Ranallo told the court that it was Mr. Black who requested that she misstate the balances.[104] Elmore prepared financial statements based upon this information, but once he found out about the loans, he contacted Mr. Black.[105] Based upon the false statements of financial condition, Travelers issued bonds on behalf of Leahey for numerous projects between September 1996 and February 1997.[106] Finally, in February, Travelers learned of Leahey's

[94] *Leahey Construction*, 219 F.3d at 524-25.
[95] *Id.* at 525.
[96] *Id.*
[97] *Id.*
[98] *Id.*
[99] *Id.* at 526.
[100] *Id.*
[101] *Id.* at 529.
[102] *Id.*
[103] *Id.*
[104] *Id.*
[105] *Id.* at 528.
[106] *Id.* at 529-30.

defaults on numerous projects and quit issuing bonds.[107] Ultimately, Travelers sustained losses of over $2.5 million due to Leahey's defaults.[108]

Travelers sued Leahey and his wife for the losses.[109] After the Leaheys declared bankruptcy and Travelers obtained a default judgment against them, Travelers amended their complaint adding KeyBank, KeyCorp (KeyBank's parent company), Donnelly (banker), and Elmore (outside accountant) for more than ten causes of action.[110] Ultimately, the Sixth Circuit Court of Appeals upheld the jury's findings of aiding and abetting fraud against KeyBank and Donnelly, but reversed the findings of aiding and abetting fraud and conspiracy against Elmore and remanded the $2.6 million jury verdict for reconsideration in light of the court's findings.[111]

C. Theories of Liability

Fraud

Fraud is a cause of action whereby one party intentionally makes false representations to deceive or induce action of the other party.[112] When a principal's accountant, banker, lawyer, and/or bonding agent make representations to a surety with the intent to deceive the surety regarding the financial condition of a principal, they have committed fraud. State law controls causes of action for fraud.

For example, in *Leahey Construction*, the district court stated:

> To establish a claim for fraud under Ohio law, a plaintiff must prove the following elements: (a) a representation or, where there is a duty to disclose, concealment of a fact, (b) which is material to the transaction at hand, (c) made falsely, with knowledge of its falsity, or with such utter disregard and recklessness as to whether it is true or false that knowledge may be inferred, (d) with the intent of misleading another into relying upon it, (e) justifiable reliance upon the representation or concealment, and (f) a resulting injury proximately caused by the reliance.[113]

In that case, the court found that while the surety doesn't have to show that the actor had actual knowledge of the fraud, it had to show that the actor acted recklessly.[114] Here, the court held that there was sufficient evidence that KeyBank and Elmore knew of the falsities of the financial information provided the surety to overcome a summary judgment motion.[115] However, upon appeal, the Sixth Circuit Court of Appeals held that KeyBank and Elmore were fraudulent, but the proper cause of action against them was aiding and abetting fraud, not just fraud, as they were assisting in providing false financial statements in order to deceive the

[107] *Id.* at 530.
[108] *Id.* at 524.
[109] *Id.* at 530.
[110] *Id.*
[111] *Id.* at 547.
[112] *Matter of Pappas*, 661 F.2d 82, 86 (7th Cir. 1981).
[113] *Leahey Construction*, 22 F.Supp.2d at 701.
[114] *Id.*
[115] *Id.* at 702.

surety as opposed to being the sole originator and provider of the statements.[116]

Aiding and Abetting

One possible remedy against parties who assist in falsifying financial documents and providing them to another who relies upon them is aiding and abetting. The Restatement (Second) of Torts states that aiding and abetting is "for harm resulting to a third person from tortious conduct of another, one is subject to liability if he . . . knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself . . . ."[117] This cause of action can be maintained against parties who participate in preparing or encouraging the principal to prepare false financial statements in order to obtain bonding. It may take the form of aiding and abetting fraud and/or aiding and abetting breach of fiduciary duty the officers, owners, and/or directors owe the creditors who answer for the principal. Regardless of the form it takes, the specific elements of aiding and abetting, and the other forms of liability discussed below, depend entirely upon the state law that governs the proceeding.

In *Leahey Construction*, the court used the Restatement approach (consistent with Ohio law) when analyzing the aiding and abetting fraud allegations against Elmore, the principal's outside accountant.[118] In that case, Elmore contended that knowing that the short-term loan was for bonding purposes, without knowledge regarding bonding and that a surety would rely upon the statements, was insufficient to find that he had actual knowledge of the fraud.[119] Despite opposing testimony from Ranallo that Elmore knew of the misrepresentations in the financial statements, the court found that there was insufficient evidence proving Elmore knew at the time he made his representations that they were wrong.[120] For this reason, the court reversed the finding of aiding and abetting fraud against Elmore.[121] However, had the surety been able to provide more evidence that Elmore knew the false financial statements would be relied on by the surety, the court would have likely found Elmore liable for aiding and abetting fraud.

When establishing a claim of aiding and abetting, knowledge may be shown by circumstantial evidence.[122] Therefore, it is important to carefully review financial records seeking discrepancies between what the accountant/auditor provided and what he was furnished by the principal to support the assertion that he had knowledge of the falsity of the statements.

Conspiracy

Most aiding and abetting allegations are accompanied with allegations of conspiracy. One court has held that "liability for civil conspiracy is in substance the same thing as aiding

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[116] *Leahey Construction*, 219 F.3d at 533-34.
[117] Restatement (Second) of Torts §876(b) (1979); ***Failla v. City of Passaic***, 146 F.3d 149, 158 (3rd Cir. 1998)(Courts have recognized that . . . Restatement [Section 876(b)] sets forth the standard of civil aiding and abetting liability).
[118] *Leahey Construction*, 219 F.3d at 539.
[119] *Id.*
[120] *Id.*
[121] *Id.* at 547.
[122] *Metge v. Baehler*, 762 F.2d 621, 625 (8th Cir. 1985).

and abetting liability."[123] The difference between the two is that aiding and abetting hinges on whether the defendant knowingly gave "substantial assistance" to the wrongdoer while conspiracy hinges upon whether the defendant "agreed to join in" the wrongful conduct.[124] Therefore, conspiracy is more difficult to prove then aiding and abetting. However, parties assisting a principal in the preparation of financial statements may be found liable for conspiracy if it can be proven that the parties agreed to join in the wrongful activity.

In *Leahey Construction*, the court used Ohio's definition of civil conspiracy and stated that "in order to establish a claim of civil conspiracy, the following elements must be proven: '(1) a malicious combination; (2) two or more persons; (3) injury to person or property; and (4) existence of an unlawful act independent from the actual conspiracy.'"[125] The court found Donnelly (banker) and KeyBank (bank) did not agree to join in the tortious activity. The court held that "[a]lthough it was reasonable for the jury to infer, based on the circumstantial evidence presented by Travelers, that Donnelly knew that Leahey was engaging in tortious conduct, it was unreasonable for the jury to further infer that Leahey 'agreed to join in' his scheme."[126] The court upheld the jury's findings that Donnelly and KeyBank were guilty of aiding and abetting fraud because they assisted Leahey, but reversed the findings that they were guilty of civil conspiracy because there was insufficient evidence to prove they agreed to join in the tortious activity.[127]

Negligent Misrepresentation

Many states recognize Section 552 of the Restatement (Second) of Torts which states that professionals who supply false information for the guidance of others in their business transactions, and fail to exercise reasonable care or competence in obtaining or communicating the information, may be liable to others for their losses when justifiably relying upon the information.[128] However, negligent misrepresentation is only available when the professional knows or should have known that someone else would rely upon the information he is providing. For example, one Texas court held an accountant could be liable to his client's creditors under negligent misrepresentation if he knew or should have known that the creditors were in the limited class of people who may rely upon the information he provided.[129] Therefore, depending upon the state laws, a principal's accountant or lawyer may be liable to a surety for negligent misrepresentation when preparing the financial documents the surety relies on when considering whether to bond a principal.

For example, in *Leahey Construction*, Travelers (surety) successfully asserted a negligent misrepresentation claim against Elmore (outside accountant). Under Ohio law, the surety proved: "(1) a duty between the accountant and his client; (2) the accountant failed to exercise the necessary skill and knowledge normally possessed by members of his profession; (3) the client justifiably relied upon the information or advice given by the accountant; and (4) the client suffered pecuniary loss."[130] The court stated "[a]ccountants have a duty to provide

[123] *K&S Partnership v. Continental Bank*, 952 F.2d 971, 980 (8th Cir. 1991).
[124] *Halberstan v. Welch*, 705 F.2d 472, 478 (D.C.Cir. 1983).
[125] *Leahey Construction*, 219 F.3d at 534.
[126] *Id.* at 538-39.
[127] *Id.*
[128] Restatement (Second) of Torts §552.
[129] *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408 (Tex.App.—Dallas 1986, writ ref'd n.r.e.).
[130] *Leahey Construction*, 22 F.Supp.2d at 704.

accurate information."[131] Travelers proved that Elmore knew of the $275,000.00 loan and knew it was repaid four days later, but never included this information in the financial documents he furnished.[132] The court stated "[a]n accountant may also 'be liable in negligence for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons.'"[133] By bonding Leahey, Travelers relied upon the financial information from Elmore to its detriment, as it sustained losses exceeding $2.5 million.[134] For these reasons, Elmore was found by a jury to be guilty of negligent misrepresentation.[135]

The above theories of liability are a few examples of ways parties assisting a principal in falsifying financial documents may expose themselves to liability. However, the theories available in a case depend entirely upon the state law governing the proceeding. While these examples are possibilities, this list is not exhaustive and a party bringing a claim against the other bad guys should refer to state law to determine the possible theories of liability available. Regardless of which theory is used, a judgment against one of the other bad guys may also be declared nondischargeable due to the presence of fraud as a basis for the liability itself.

D. Are Judgments Against the Bad Guys Dischargeable?

In addition to providing false financial statements, acting fraudulently is also a means of creating a nondischargeable debt. 11 U.S.C.A. §523(a)(2)(A) provides that a debtor will not be discharged of any debt "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . false pretenses, a false representation, or actual fraud . . . ."[136] A judgment debt falls within the class of debts declared nondischargeable under Section 523(a)(2)(A).[137] Bankruptcy courts apply collateral estoppel when determining whether a judgment debt resulting from a fraud claim is dischargeable.[138] Therefore, if a surety obtains a judgment against a principal's accountant, banker, lawyer, and/or bonding agent for fraud, aiding and abetting fraud, or conspiracy to commit fraud, collateral estoppel will prevent the court from rehearing the allegations of fraud and the judgment debt will be held nondischargeable by a court.

Furthermore, one court has stated the "[i]ntent to deceive may be inferred, of kind required in order to except debt from discharge as one obtained by debtor's 'false pretenses, false representations, or actual fraud,' where debtor recklessly makes false representations that he should know will induce another to rely thereon."[139] If one of the bad guys recklessly makes false representations that he should know the surety will rely on, it may be inferred that he maintained the intent to deceive. Therefore, if he is found, from the surrounding circumstances, to have maintained the intent to deceive, then debts resulting from that deception will likely be declared by a bankruptcy court as nondischargeable under Section

[131] *Id.*
[132] *Id.* at 699.
[133] *Id.* at 704.
[134] *Id.* and *Leahey Construction*, 219 F.3d at 524.
[135] *Leahey Construction*, 219 F.3d at 524.
[136] 11 U.S.C.A. §523(a)(2)(A).
[137] *See In re Detrano*, 326 F.3d 319 (2nd Cir. 2003).
[138] *Id.* at 322 (Where the debt in question is a judgment entered after a claim of fraud has been adjudicated, either party to a subsequent adversary proceeding on nondischargeability can invoke collateral estoppel to establish that the debt is or is not dischargeable under the relevant nondischargeability provision).
[139] *In re McKnew*, 270 B.R. 593, 620 (E.D. Va. 2001).

523(a)(2)(A). For this reason, a surety's judgment debt resulting from successful claims against the bad guys for negligent misrepresentation and/or other tort causes of action may be declared nondischargeable if an intent to deceive can be inferred.

V. CONCLUSION

The surety who provides bonds to a principal assumes a tremendous amount of risk when underwriting those bonds. This paper analyzes possible courses of action a surety may maintain against a defaulting principal who, to avoid its obligation to the surety, seeks bankruptcy. While the principal, including its owners, officers, and directors, is the first source of recovery in such situations, it is not the sole source. There may be an open door of recovery against the principal's accountants, bankers, lawyers, and/or bonding agents who fraudulently or deceptively assisted the principal in falsifying the financial documents the surety relied upon to its detriment. Judgment debts against these other bad guys arising from such fraudulent or deceptive actions will likely be held nondischargeable in bankruptcy. Thus, bad guys, other than the principal, may be left with no way out and forced to pay.

BIOGRAPHY

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