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Discharge in Bankruptcy of Principal's Inchoate Obligation to Indemnify His Surety

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DISCHARGE IN BANKRUPTCY OF PRINCIPAL'S INCHOATE OBLIGATION TO INDEMNIFY HIS SURETY.—In the recent case of *R. P. Williams, et al.* v. *United States Fidelity and Guaranty Company*, 35 Sup. Ct. 289, the United States Supreme Court has at last passed upon a question that has vexed the courts ever since the enactment of the Bankruptcy Act of 1898. As stated by the Supreme Court, the question is this: "Does a discharge in bankruptcy acquit an express obligation of the principal to indemnify his surety against loss by reason of their joint bond conditioned to secure his faithful performance of a building contract broken prior to the bankruptcy when the surety paid the consequent damage thereafter?" and the question was answered in the affirmative, reversing the decision of the Court of Appeals of Georgia (11 Ga. App. 635).

The facts were briefly: in 1900 the defendants entered into a contract to build a school-house for certain trustees, and gave a bond, with plaintiff company as surety, to secure the performance of the contract; in obtaining this bond defendants agreed that they would indemnify plaintiff company against all loss accruing by reason of its becoming surety, etc. Defendants defaulted on their contract, the trustees completed the school-house and on May 14, 1901, made demand for the amount expended by them beyond the contract price. On May 28, 1901, defendants became voluntary bankrupts and eventually received their discharge; their schedules specified the building contract, its breach and the bond. The trustees proved their claim against the defendants, but no dividend was paid because of deficiency of assets. Thereupon the trustees sued plaintiff company and in 1904 recovered a judgment which plaintiff company paid in 1905; plaintiff company now sues on the defendants' contract to indemnify it, and claims that the discharge in bankruptcy is no defense because, to use the words of the Georgia court, "The bankrupts owed the surety nothing at the time the petition in bankruptcy was filed, because the surety had paid nothing for their benefit and the relation of debtor and creditor did not exist between them until after actual payment by the surety. * * * The surety had no claim against the bankrupts which it could file in its own name. * * * The liability to the surety by the bankrupts was altogether contingent and might never have arisen."

The opinion of the court (delivered by Mr. Justice McREYNOLDS) cites in support of its holding, *Mace* v. *Wells*, 7 How. 272; *Fairbanks* v. *Lambert*, 137 Mass. 373; *Hayer* v. *Comstock*, 115 Iowa 187; *Post* v. *Losey*, 111 Ind. 74; *Smith* v. *Wheeler*, 55 App. Div. 170, 66 N. Y. Supp. 780; of these cases only *Hayer* v. *Comstock* and *Smith* v. *Wheeler* were decided under the Act of 1898, the others being decided under the Acts of 1841 and 1867, both of which permitted the proof of many claims not provable under the Act of 1898. The court does not, however, make any very definite reference to any authorities, but bases its decision on reasoning which is well exemplified by the following quotation:

"It would be contrary to the basal spirit of the Bankrupt Law to permit a surety, by simply postponing compliance with his own promise in respect of a liability until after bankruptcy, to preserve a right of recovery over against his principal notwithstanding the discharge would have extinguished this if the surety had promptly performed as he agreed. Such an interpretation would effectually defeat a fundamental purpose of the enactment. The written indemnity agreement embodied in the bankrupt's application to the surety company for execution of the bond, so far as its terms are important here, but expressed what otherwise would have been implied from the relationship assumed by the parties. At the time of the bankruptcy the obligation under this agreement was ancillary to a liability arising out of a contract estimation of which was easy of establishment by proof. There was no uncertainty which could prevent the surety from obtaining all benefits to which it was justly entitled from the bankrupt estate." The court cites several sections of the Act bearing on the proof of claims, and concludes that they furnish the surety complete protection, principally because the surety has the right to insist upon a proof of the claim on which he is liable, under § 57i, and thus shares in the principal's estate by receiving the benefit (in the form of a decreased liability) of the dividends that are paid on the claim thus proved.

While the Supreme Court's solution of this difficulty doubtless arrives at a desirable result, it seems fairly clear that it accomplishes this result only by disregarding some sections of the Act and by distorting others. The discharge of obligations in bankruptcy is, of course, governed by § 17 of the Act, which provides that: "A discharge in bankruptcy shall release a bankrupt from all of his provable debts, except such as * * * (3) have not been duly scheduled in time for proof and allowance, with the name of the creditor if known to the bankrupt * * *." To be discharged, then, a debt must have been provable and must have been duly scheduled.

First, as to whether the debt was provable. If provable, it is because it meets the language of § 63a (4), providing for the proof of claims "founded upon an open account, or upon a contract express or implied." It has been pretty generally held (*In re Swift*, 112 Fed. 315, 50 C. C. A. 264; *In re Adams*, 130 Fed. 381; *In re Roth & Appel*, 181 Fed. 667, 104 C. C. A. 649; *Colman Co.* v. *Withoft*, 195 Fed. 250, 115 C. C. A. 222) that this language in § 63a (4) is limited by the phrase "owing at the time of the filing of the petition" in § 63a (1), and that no claim if provable, therefore, unless it was absolutely owing when the petition was filed; there are, however, cases to the contrary (*Moch* v. *Market Street Bank*, 107 Fed. 897, 47 C. C. A. 49, and cases following its reasoning), and the Supreme Court has heretofore declined to express a definite opinion on the point (see *Dunbar* v. *Dunbar*, 190 U. S. 340, at page 350). It has been universally held in the lower courts that a surety's claim against his bankrupt principal for indemnification cannot be made the basis for the surety's joining as a creditor in an involuntary petition (*Phillips* v. *Dreher Shoe Co.*, 112 Fed. 404) nor can the surety, in his own name, normally prove such claim in the bankruptcy proceeding (*Insley* v. *Garside*, 121 Fed. 699, 58 C. C. A. 119; *In re Dr. Voorhees Co.*, 187 Fed. 611; *In re Manhattan Brush Co.*, 209 Fed. 997). It has been held quite as universally, in *Swarts* v. *Siegel*, 117 Fed. 13, 54 C. C. A. 399 and the numerous cases following it, that a surety (especially an indorser of commercial paper) is a creditor who may be preferred by a debtor principal who becomes bankrupt within four months after the transaction complained of. See 60 UNIV. OF PA. LAW REV. 482, where the authorities are collected and discussed.

The Supreme Court does not hold that the surety's claim against the principal is a provable claim under the Act; it says: "Within the intendment of the law provable debts include all liabilities of the bankrupt founded on contract, express or implied, which at the time of the bankruptcy were fixed in amount or susceptible of liquidation," thus apparently favoring the view taken in *In re Swift*, rather than that taken in *Moch* v. *Market Street Bank*. But the debt sued on in the principal case, while "founded on contract" was certainly not "at the time of the bankruptcy fixed in amount or susceptible of liquidation." The trustees might never have sued, in which case the debt never would have arisen; the suit might have resulted in a judgment in favor of the surety company, in which case the liability of the principals would have been only for the expenses of defending the suit; a judgment might have been rendered against the surety company for much or for little; and it was very likely (as was actually the case) that none of these possibilities would occur for several years after the bankruptcy. So it is difficult to believe that the Supreme Court intended to hold that the debt sued on was a provable debt under the terms of the Act.

Second, as to whether the debt was scheduled. The Supreme Court does not discuss this point, saying: "The schedules specified the building contract, its breach and the bond, and their adequacy is not now questioned." The building contract and the bond would, of course, be scheduled as debts owing by the bankrupts to the trustees (obligees) and not as a debt owing by the bankrupts to the surety. The only reasonable ground for the decision of the Court, then, seems to be that the obligation of the bankrupts to their surety was discharged, not because it was provable or scheduled, *as an independent obligation*, but because it was ancillary to a provable and scheduled obligation. And it must be admitted that the result attained is desirable; as the Court aptly says: "It is the purpose of the Act to * * * relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes," and again: "a discharge in bankruptcy may have very small value for the luckless debtor who faithfully tried to secure his creditors against loss" if a contrary holding were made. But it must also be admitted that there are many kinds of claims which are not discharged by bankruptcy, and that there is no warrant in the statute for the Supreme Court's doctrine of ancillary discharge.

The decision also leaves a dilemma as to the cases (like *Swarts* v. *Siegel*, supra) which hold that a surety is a creditor having a provable claim and therefore is preferred by a payment which relieves him of liability, or lessens his liability, as surety; if, as the Supreme Court intimates in the principal case, the obligation of the principal to his surety is discharged not because it is provable and scheduled, but because of its ancillary character, what becomes of the doctrine that such an obligation *is* provable, which is of course the basis of the decisions in the preference cases? And of course the decision is not authoritative as to cases like *Goding* v. *Rosenthal*, 180 Mass. 43, where at the time of bankruptcy there had not even been a default on the principal's obligation; in such cases it could not be said that estimation of the liability on the original contract (to which the contract in question was ancillary) was easy of establishment by proof. E. H.