

## **SURETY TODAY PRESENTATION**

Given by  
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### **Bankruptcy: The Surety's Proof of Claim**

(MIKE)

This is the third presentation in a series of surety/bankruptcy related presentations that George and I have given. As I have mentioned before, our Surety Law Group has extensive experience in the bankruptcy arena - having represented sureties in bankruptcy courts in large and small matters all over the country and having written and presented on the subject extensively.

On November 13, 2017, we discussed the Automatic Stay and the Property of the Debtor's bankruptcy estate. Last month, on December 11, 2017, we discussed the Debtor's and the Surety's rights to the bonded contract funds in bankruptcy. We covered Section 363 of the Code – Use of cash collateral, the rights of the various parties, the defenses of the surety, and various practical tips.

Today we will focus on the Surety's Proof of Claim in bankruptcy. One of the primary functions of the bankruptcy process is to ensure that the Debtor's pre-petition unsecured creditors share equally in the distribution of the property of the estate. The Proof of Claim is one of the important tools for accomplishing that fair distribution of the Debtor's property.

I will get us started with a brief introduction to Proof of Claims, George will follow with a more in-depth look at the types of claims that may be asserted. I will then discuss the relationship between reimbursement claims and subrogation claims under the Bankruptcy Code. Next, George will address the claims administration process and I will discuss the claims objection process. Finally, George will close by touching briefly on post-petition claims.

#### **Proof of Claims Generally**

Let's start with a 30,000 foot overview of bankruptcy. When the debtor files a bankruptcy case, no matter whether it's a chapter 7, 11, or 13, whether there is a trustee involved or a debtor in possession, that filing establishes a bankruptcy estate that is comprised of all of the Debtor's property and assets. As we discussed in the prior presentations, the Bankruptcy Code purposefully defines property of the bankruptcy estate exceedingly broad so as to capture all of the Debtor's property wherever located and by whomever held and in whatever form.

Once all of the property is gathered into the estate it is then distributed to the creditors in an orderly and organized fashion in accordance with the provisions of the Bankruptcy Code. The

Bankruptcy Code addresses treatment and priority of Administrative Claims and Secured Claims, which George will explain in a moment. To the extent that there is any estate property that is free and clear of the claims of secured and priority creditors that amount of the Debtor's property will be distributed to the Debtor's pre-petition unsecured creditors.

To help identify what the Debtor's assets are and who the Debtor's creditors are under the Bankruptcy Code, under Section 521 of the Code the Debtor is required to file schedules identifying its assets and creditors. In order to share in any distribution under a plan or liquidation from a bankruptcy estate, the surety must be listed as a creditor with an undisputed and liquidated claim.

The problem is that frequently the surety may not be listed in the Debtor's schedules as a creditor, or if the surety is listed, the amount of the surety's claim is not listed correctly, or even if the surety's claim is correctly listed it will typically be identified as "disputed." In addition, at the time a principal or indemnitor files bankruptcy the surety's claims are typically not fully liquidated, as the surety may still be dealing with claims and performance issues. Accordingly, the surety will need to advise the Debtor, any trustee and the court of the true and correct nature of the surety's claims through the filing of a Proof of Claim under Section 501 of the Bankruptcy Code.

But first, let's look at what is a "claim" under the Code, because you can't file a Proof of Claim unless you first have a claim. The Bankruptcy Code defines a "claim" at Section 101(5) as a:

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured;

The Bankruptcy Code definition of "claim" is extremely broad and extends to practically every type of claim that a surety may have against the Debtor. Even if the claim is totally contingent and may never become an actual loss for the surety it would still constitute a claim in bankruptcy. It is important to note that the surety's claims typically arise out of an indemnity agreement and bonds that were executed prior to the filing of bankruptcy. Thus, payments made by the surety after the filing of bankruptcy are included in the surety's claim, because such payments will relate back to the pre-petition obligation.

(GEORGE)

### **The Types of Surety Pre-Petition Claims in a Debtor's Bankruptcy Case**

A. Generally.

As Mike just stated, a surety's claim is a right to payment from the Debtor. The surety has a reimbursement claim for its losses, which losses may include:

1. Payments under the surety bonds to obligees and other third-party claimants;
2. Payments for losses under the Indemnity Agreement, including professional fees and expenses; and
3. Payments for premiums for the surety bonds.

Each of these payments may be or have been “reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, [or] undisputed.” Regardless, they are included in a surety’s claim for reimbursement.

The surety, whether it is a contract bond surety or a commercial bond surety, wants to be reimbursed for its payments and losses, and has significant rights – “legal, equitable, secured, or unsecured” – outside of a bankruptcy case. The surety has:

1. Common law<sup>1</sup> and Indemnity Agreement contractual rights of reimbursement;
2. Rights against any collateral that the surety is holding; and
3. Subrogation rights.

The question is how these rights are affected by and enforceable in a Debtor’s bankruptcy case based upon the various types of claims that a surety may have.

B. The types of surety claims.

1. *The Surety’s Secured Claim - Section 506 of the Bankruptcy Code*

The surety’s reimbursement claim may be secured by rights in or a lien on collateral which may be property of the Debtor’s bankruptcy estate. While the automatic stay may prevent the surety from exercising and enforcing its rights against the collateral,<sup>2</sup> the surety’s lien rights<sup>3</sup> and other rights in certain collateral may provide the surety with a secured claim against the Debtor’s real and/or personal property under section 506 of the Bankruptcy Code. The collateral and the surety rights may include:

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<sup>1</sup> The surety’s common-law claim for reimbursement and/or indemnity against its principal is described in the RESTATEMENT OF THE LAW (THIRD), SURETYSHIP AND GUARANTY (1996), section 22(1), which states that “when the principal obligor is charged with notice of the secondary obligation it is the duty of the principal obligor to reimburse the secondary obligor to the extent that the secondary obligor” performs the secondary obligation or settles with the obligee, thereby discharging the debt of the principal obligor.

<sup>2</sup> While a surety may have a secured claim and either lien rights or other rights in the principal’s real and/or personal property, when the principal files its bankruptcy petition and becomes a debtor, the surety is automatically stayed from exercising its rights against the Debtor’s real and/or personal property under section 362 of the Bankruptcy Code. The surety must seek to modify, condition, or terminate the automatic stay under section 362(d) of the Bankruptcy Code and obtain a court order prior to exercising and enforcing its rights against the Debtor’s property.

<sup>3</sup> 11 U.S.C. §101(37) defines a “lien” to mean a “charge against or interest in property to secure payment of a debt or performance of an obligation.” Thus, any surety interest in the Debtor’s property to secure the payment of a debt owed to the surety may give rise to a secured claim.

- a. Letter of Credit. The surety may have received a letter of credit as collateral, which we have discussed previously in other presentations. The letter of credit and the proceeds of the letter of credit are not property of the Debtor's bankruptcy estate, and the surety is not automatically stayed or prevented from drawing on the letter of credit or using the letter of credit proceeds to pay claims or reimburse the surety for its losses.
- b. Contractual lien rights. The surety may have obtained as collateral mortgages and deeds of trust against the Debtor's real property and security agreements and perfected security interests in the Debtor's personal property, including cash.<sup>4</sup>
- c. Indemnity agreement secured rights. The surety may have a perfected security interest under the Indemnity Agreement in collateral with the filing of a UCC-1 Financing Statement.
- d. Collateral demand/place in funds rights. The surety may have established a reserve and demanded collateral or to be "placed in funds" under the Indemnity Agreement, and may be holding collateral as a result.
- e. Judicial liens. The surety may have obtained a judgment against the principal, now the Debtor, under the Indemnity Agreement and recorded that judgment under state law as a lien against the principal's property.<sup>5</sup>
- f. Setoff rights. The surety may have certain setoff rights against the principal that may provide either a recovery to the surety or the avoidance of an additional loss.<sup>6</sup>
- g. Indemnity agreement trust fund rights. The surety may have applicable trust fund rights under the Indemnity Agreement, which we have discussed previously in other presentations.
- h. Subrogation rights. The surety may be secured by its subrogation rights to the rights of others, including the surety's subrogation rights against third

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<sup>4</sup> Under 11 U.S.C. § 101(50), a "security agreement" means an "agreement that creates or provides for a security interest." Under 11 U.S.C. § 101(51), a "security interest" means a "lien created by an agreement." The surety's liens and security interests may be created at the time that the indemnity agreement is executed or at any time thereafter.

<sup>5</sup> Under 11 U.S.C. § 101(36), a "judicial lien" means a "lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding."

<sup>6</sup> Pursuant to the automatic stay of section 362(a)(7) of the Bankruptcy Code, the surety is stayed from exercising any setoff rights that it may have in the event that the surety owes a debt to the Debtor that arose before the Petition Date against any claim that the surety may have against the Debtor, and the surety's setoff rights may only be exercised after the surety obtains a court order granting relief from the automatic stay (termination, modification or conditioned) allowing the surety to exercise and enforce its setoff rights.

parties, rights against collateral held by the bond obligee, namely the bonded contract funds, and statutory lien rights.<sup>7</sup>

The surety should file a proof of claim for its secured claim.<sup>8</sup>

The surety's rights as a secured creditor against the Debtor's property are governed by section 506 of the Bankruptcy Code. The surety's allowed secured claim is secured by a lien on the Debtor's property to the extent of the value of the surety's interest in the Debtor's estate's interest in the property.

For example, if the surety's total secured claim is \$100,000, and the value of the Debtor's estate's interest in the property net of the amount of the prior liens that are superior to the surety's lien is in excess of \$100,000, then the surety has a fully secured claim. However, to the extent that the surety is only partially secured – namely, the surety's total secured claim is \$100,000, but the value of the Debtor's estate's interest in the property is less than \$100,000 – the surety will have a partially secured claim to the extent of the value of the Debtor's estate's interest in the property and a partially unsecured claim with respect to the deficiency between the surety's total claim of \$100,000 and the value of the Debtor's estate's interest in the property.<sup>9</sup>

There are two variables to any creditor's secured claim - the amount of the claim and the value of the collateral securing the claim. The surety frequently finds that both the amount of its claim<sup>10</sup> (the surety's payments and the surety's contingent and unliquidated liabilities under the bonds) and the value of its collateral<sup>11</sup> (the value and extent of the surety's liens and rights) are variable and/or unknown. The surety should file its proof of claim as a secured claim

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<sup>7</sup> The term "statutory lien" is defined in 11 U.S.C. § 101 (53) and does not include a "security interest" or a "judicial lien."

<sup>8</sup> Pursuant to section 506(d)(2) "[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void unless - . . . (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title." Therefore, if, in fact, a surety has a lien against the Debtor's property, which is property of the bankruptcy estate, and the surety fails to file a proof of claim, that lien will remain on the Debtor's property despite the surety's failure to file a proof of claim. It is not recommended that the surety fail to file a proof of claim.

<sup>9</sup> 11 U.S.C. § 506(a), which also provides that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."

<sup>10</sup> Pursuant to 11 U.S.C. § 502(c), the bankruptcy court may estimate for the purpose of the allowance of a claim "(1) any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case; or (2) any right to payment arising from a right to an equitable remedy for breach of performance."

<sup>11</sup> Pursuant to Bankruptcy Rule 3012, "[t]he court may determine the value of a claim secured by a lien on property in which the estate has an interest on motion of any party in interest and after a hearing on notice to the holder of the secured claim and any other entity as the court may direct."

notwithstanding the potential unliquidated, disputed and/or contingent nature of the surety's claim.

Finally, the surety may be entitled to reimburse its secured claim from the collateral for the surety's payments to its attorneys, consultants and others, and for interest on its payments under section 506(b) of the Bankruptcy Code.

2. *The Surety's General Unsecured Claim - Sections 501 and 502 of the Bankruptcy Code*

The surety's reimbursement claim may be a pre-petition general unsecured claim against the Debtor. The surety must file a proof of claim for the amount of its pre-petition losses, interest and professional expenses in order to obtain a pro rata distribution of the Debtor's property under a plan or liquidation. Those pre-petition losses may be pre-petition in nature even if they are incurred or paid post-petition.<sup>12</sup> The surety may be able to include such incurred and paid professional expenses as part of its pre-petition general unsecured claim.

The surety's proof of claim for its general unsecured claim is based on its common-law rights of reimbursement and its indemnity and reimbursement rights under the Indemnity Agreement, and possibly its subrogation rights. The surety should include in its liquidated, non-contingent and undisputed claim all of the surety's paid losses, including fees and professional expenses, and any unpaid premiums. The surety's proof of claim must reserve the surety's right to amend and/or supplement its proof of claim to add any additional liabilities and to reflect the surety's actual losses and expenses (the surety's liquidated loss). Finally, the surety's proof of claim should assert its contingent and unliquidated claim for all of the surety's possible liabilities and losses in an amount equal to the penal sums of all of the outstanding bonds, less any paid losses to date.

3. *The Surety's Priority Unsecured Claim - Sections 503 and 507 of the Bankruptcy Code*

A surety with a pre-petition general unsecured claim rarely, if ever, has a priority claim to the property of the Debtor's bankruptcy estate as against other general unsecured pre-petition claims. Section 507 of the Bankruptcy Code sets forth certain specific pre-petition claims that have priority over other general unsecured pre-petition claims. The Indemnity Agreement does not assign to the surety any of the priority rights of a creditor asserting a priority unsecured claim. Furthermore, under section 507(d) of the Bankruptcy Code, the surety may not be subrogated to the priority rights of a creditor in the event that the surety pays as part of the

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<sup>12</sup> Pursuant to 11 U.S.C. § 502(e)(2):

A claim for reimbursement or contribution of such an entity that becomes fixed after the commencement of the case shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) of this section, the same as if such claim had become fixed before the date of the filing of the petition.

*See also* 11 U.S.C. § 501(d).

surety's bond obligations, such as a tax or customs bond, the claim of the creditor that would otherwise have priority rights.<sup>13</sup>

However, the surety may become subrogated to the priority rights of a creditor if the surety pays a claim that is a post-petition administrative expense claim allowed under the Bankruptcy Code. The surety's proof of claim must reserve the surety's right to amend and/or supplement its proof of claim in order to preserve any priority claims that the surety may have.

4. *The Surety's Reserve Claim*

Pursuant to the Indemnity Agreement, the surety may establish a reserve to cover claims, demands, liabilities, etc. The surety's establishment of a reserve constitutes a loss on the surety's books, and may be the basis for a portion of the surety's pre-petition claim, whether the surety's claim is a secured claim or a general unsecured claim, even if the surety has not actually paid losses up to the amount of the reserve.<sup>14</sup>

5. *The Surety's Contingent and Unliquidated Claim for Reimbursement Under Section 502(e) of the Bankruptcy Code*

The surety may have a contingent and unliquidated claim for reimbursement. Mike will discuss this situation and claim later.

6. *The Surety's Executory Contract Rejection Claims*

The surety may have a claim if the Debtor rejects an executory contract and such rejection causes a loss to the surety.<sup>15</sup> While such a rejection may result in the obligee's filing a bond claim and cause a subsequent loss to surety, the surety's rejection claim may be necessary if the proof of claim bar date has expired and the surety's general unsecured claim has already been disallowed.

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<sup>13</sup> Section 507(d) of the Bankruptcy Code provides as follows:

An entity that is subrogated to the rights of a holder of a claim of a kind specified in subsection (a)(1), (a)(4), (a)(5), (a)(6), (a)(7), (a)(8), or (a)(9) of this section is not subrogated to the right of the holder of such claim to priority under such subsection.

<sup>14</sup> See THE SURETY'S INDEMNITY AGREEMENT – LAW & PRACTICE, 2D ED. 481-83 (Marilyn Klinger, George J. Bachrach and Tracey L. Haley eds., 2008). The surety's reserve claim may be estimated for purpose of allowance if it is found to be a contingent or unliquidated claim when the failure to fix or liquidate the claim would "unduly delay the administration of the [debtor's] case." 11 U.S.C. § 502(c).

<sup>15</sup> 11 U.S.C. § 502(g). See also 11 U.S.C. § 501(d). Any claim that the surety may have arising from the rejection of the contract and/or commercial surety bond (or bonds) as an executory contract shall be determined, and allowed or disallowed, "the same as if such claim had arisen before the date of the filing of the petition."

7. *The Surety's Claim Resulting From the Return of Property Due to an Avoidance Action (Preferential or Fraudulent Transfer)*

It is possible that the surety may obtain collateral and/or property of the principal that results in the surety receiving a preferential transfer due to the principal's filing of its bankruptcy petition. The surety is entitled to increase its secured or unsecured proof of claim to the extent that the surety must return property subject to the avoidance action to the Debtor's estate.<sup>16</sup>

(MIKE)

**The Connection Between the Surety's Reimbursement and Subrogation Claims**

A surety that pays a claim under a bond may have two types of claims under the Bankruptcy Code: (1) a claim for reimbursement or contribution under Section 502 of the Code, and (2) a subrogation claim under Section 509 of the Code. The Bankruptcy Code does not allow the surety to have an allowed claim in both categories because that would permit it to effectuate a double recovery. Section 502(e)(1)(C) provides that the court shall *disallow* any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that . . . such entity asserts a right of subrogation to the rights of such creditor under Section 509.

Section 509(a) provides, "an entity that is liable with the debtor on, or that has secured a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment." Thus, Section 509 codifies the basic concept of subrogation.

There is a dispute among the courts as to whether Section 509 supplants and replaces equitable subrogation, whether it supplements equitable subrogation, or whether the two exist independently in bankruptcy. So, depending on what jurisdiction you are in this could have an impact on your analysis.

For subrogation to exist under Section 509 of the Code the Debtor must have been primarily liable for the indebtedness and must have received the consideration from the creditor. Of course, sureties typically satisfy this requirement.

The surety faced with a decision whether to assert a claim as reimbursement or for subrogation should carefully consider its options by reviewing all aspects of the claims. For example, if the claim for reimbursement would be secured, then it may make the most sense to seek reimbursement. On the other hand, if the reimbursement is not secured, but the claim to which the surety would be subrogated is, then subrogation may be the election, because the surety would be entitled to the creditor's secured position.

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<sup>16</sup> See also 11 U.S.C. § 501(d). Pursuant to section 502(h), a surety's claim arising from the debtor's estate's recovery of the debtor's property "shall be determined and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition."



While the surety must make an election, the surety should carefully reserve and preserve its alternative rights in its proof of claim to avoid any waiver argument.

Notwithstanding the surety's rights of reimbursement and/or subrogation, the surety will not be entitled to a distribution on its allowed claim until the creditors who are the beneficiaries of the contracts and/or bonds, whether as obligee or claimant, have been paid in full. Section 509(c) of the Bankruptcy Code provides that the bankruptcy court shall subordinate the subrogation and reimbursement claim of a co-obligor of the Debtor until the underlying creditor's claim is paid in full.

## (GEORGE)

### **The Claims Administrative Process**

To participate in any of the Debtor's distributions to general unsecured creditors and to obtain recovery from any collateral to the extent of the surety's secured claim, the surety must timely file a proof of claim, a written statement that sets forth the surety's claim. The Bankruptcy Code and the Bankruptcy Rules set out the requirements for any proof of claim.

#### A. Notices and Deadlines.

The Bankruptcy Court will send out a notice of the Debtor's filing of the bankruptcy petition. If the case is a no asset Chapter 7 liquidation, then the notice will state that fact and no proof of claim needs to be filed. If assets are later located, then a new notice with the applicable proof of claim bar date will be sent to all creditors.

If the case is an asset Chapter 7 or a Chapter 11, then the Bankruptcy Court will send a Notice of Section 341 Meeting of Creditors that sets the proof of claim bar date and deadlines. In some larger Chapter 11 bankruptcy cases, there may be a special Notice of a Bar Date Order and deadline.

If you know that one of your principals or indemnitors has filed a bankruptcy case and the surety has not received a Notice of the case from the Bankruptcy Court – which occurs very frequently – then the surety must locate where the bankruptcy case was filed and obtain any proof of claim Bar Date Orders or Notices.

#### B. The Surety's Proof of Claim – Form 410

There is a standard Form 410 cover sheet for most proofs of claim, although some large bankruptcy cases have their own cover sheet Forms. The proof of claim is filed with the Bankruptcy Court unless, in some large bankruptcy cases, a specific claims agent at some other location is named.

C. The Surety's Proof of Claim – Substance.

The Form 410 proof of claim cover sheet does not have enough room to adequately describe the surety's proof of claim. Therefore, the surety must attach the surety's proof of claim narrative that sets forth the nature of the surety's claims. This includes:

1. The type(s) of the surety's claims.
2. The basis for the surety's claims.
3. The amount of the surety's claims, whether:
  - a. Liquidated.
  - b. Contingent.

There are a number of documents to attach to the surety's proof of claim narrative. Generally, these include:

1. The Indemnity Agreement.
2. A list of the surety's bonds, but copies of the bonds do not have to be attached.
3. The amounts of the surety's payments, although a list of the surety's payments may be optional and copies of the checks or drafts do not have to be attached.

If the surety is filing a secured claim, the proof of claim narrative should include written evidence of the surety's liens and/or interests in collateral, including, where appropriate:

1. A description of the surety's liens and security interests in the Debtor's property and attaching all evidence and documents concerning the surety's liens and security interests;
2. A description of any judgment the surety has obtained against the Debtor, attaching a copy of the judgment to the proof of claim, and any other evidence and documents concerning the attachment of the judicial lien to any of the Debtor's real or personal property;
3. A reservation of any and all rights the surety has with any respect to any setoffs that the surety may have against the Debtor and any of the Debtor's claims against the surety; and
4. A description and reservation of the surety's subrogation rights to any rights against or assets of the Debtor and to the rights of others.

Finally, the proof of claim narrative should include the surety's reservation of and/or non-waiver of rights in the proof of claim. These would include:

1. The right to amend and/or supplement its proof of claim
2. The right to increase its liquidated claim
3. Priority claim rights

4. Post-petition administrative expense claim rights
5. Assumption of executory contract rights
6. Setoff rights
7. Subrogation rights (including post-petition administrative expense claim rights and non-dischargeability rights)
8. The surety's non-waiver of rights
  - a. No admission of any liability or waiver of any defenses with respect to any bond claims or indemnity agreement claims
  - b. No waiver or release of any exoneration rights
  - c. No waiver or release of any subrogation rights
  - d. No waiver or release of any other surety remedies (no election of remedies)

**(MIKE)**

**The Claims Objection Process**

Section 502 of the Code deals with the allowance or disallowance of claims. Whether a claim is allowed or not is important because it determines whether the party can participate in any distribution, and only allowed claims can vote on chapter 11 plans.

After the surety's proof of claim is executed and filed under Section 501, the proof of claim is "deemed allowed" under section 502(a) and is prima facie evidence of the validity and amount of the surety's claim. However, an objection to the surety's proof of claim may be asserted.

The claim objection process is spelled out in the Federal Rules of Bankruptcy Procedure, Rule 3007. This rule provides that any party in interest may file an objection to a claim. Parties in interest may include the Debtors, trustees, Debtors in possession and in certain limited cases may also include other creditors. Rule 3007 generally sets forth the form of the objection and procedure for filing. However, the Rule does not set a deadline for the filing of objections to claims. Section 704 of the Code regarding the obligations of trustees requires trustees to examine claims and object "if a purpose would be served." Often it will not be known until later in the case whether there are substantial assets to be distributed and thus, whether the parties and the court should invest time in determining claims objections. So, there is a pragmatic approach to the timing of objections.

Once an objection is filed, it becomes a “contested matter” and an adversary proceeding in bankruptcy and is subject to traditional *due process* requirements and Rule 9014 of the Bankruptcy Rules. It may be helpful to think of the claims objection process in the typical litigation setting – the filing of the proof of claim is similar to the filing of a complaint in a normal litigation matter and the objection to the claim is similar to an answer, once the objection/answer is filed the issues are then joined and the case proceeds as a normal litigation matter.

As noted, the filing of the Proof of Claim is considered prima facie proof of the validity and amount of the claim. Thus, the burden is on the objecting party to provide evidence disputing the claim as well as any affirmative defenses like statute of limitations, set off, usury, etc. Once the objecting party meets its burden of rebutting the prima facie claim the burden shifts to the claimant to prove its claim. The amount of a claim is determined as of the date of the filing of the bankruptcy, but as we noted earlier, payments made by the surety post-petition will relate back to the pre-petition bond or indemnity agreement.

Section 502 sets forth a number of grounds for objecting to a proof of claim. Such grounds include *inter alia*: (1) the claim is unenforceable against the debtor and property of the debtor under contract or applicable law; (2) the claim is for unmatured interest; (3) the claim was not timely filed. Rule 3007 also provides as a basis for objection that: (1) the claim is a duplicate, (2) the claim was resolved/settled or satisfied, and (3) the claim was filed in the wrong case or wrong format, among others.

Rule 3007 also establishes the so-called “Omnibus Claims Objection” which allows the objecting party to object to up to 100 claims at the same time in the same document, as long as the objections are of a procedural nature. You need to be vigilant with these omnibus objections because so many claims are lumped together it can be easy to miss the fact that an objection has been filed as to your claim

As we discussed earlier, the surety’s claim is typically under its indemnity agreement for reimbursement. Section 502(e)(1) of the Bankruptcy Code provides that:

the court *shall disallow* any claim for reimbursement or contribution of any entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that –

- (B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution;

Thus, where the surety has paid claims under its bonds and incurred attorney’s fees and consulting fees or has unpaid premiums due, such amounts are liquidated and certain and are generally recoverable as a claim under the surety’s equitable rights, common law rights or the indemnity agreement. If the surety still has exposure under bonds it issued prior to the bankruptcy and it is possible that claims may still be made some day in the future, such claims are unliquidated and contingent. The bankruptcy court must disallow the surety’s claim for

reimbursement to the extent provided in section 502(e)(1) of the Bankruptcy Code. However, if Section 506(d) applies, the surety may be able to retain a lien on any collateral for its claim.

Section 506(d) basically provides that if a claim is disallowed solely under 502(e)(1)(contingent/unliquidated) and the claimant is holding collateral, its lien on that collateral will remain. So, while the proof of claim may be disallowed, the surety will be able to retain its collateral and reimburse itself from that collateral if a disallowed contingent/unliquidated claim becomes liquidated in the future.

It should be noted that both the allowance and disallowance of a claim may be reconsidered for cause and in accordance with the equities of the case under Section 502(j).

## (GEORGE)

### **The Surety's Post-Petition Claims**

A creditor's post-petition claims are paid in full before there are any distributions to the Debtor's pre-petition general unsecured creditors. As a result, a creditor such as a surety would prefer to have post-petition claims. The surety must be aware of what it pays and the timing – not the timing of the payment but the timing of the obligation that the Debtor incurs for which the surety makes a payment under a bond.

#### A. The Surety's Administrative Expense Claim.

An allowed administrative expense claim<sup>17</sup> is one such post-petition claim that a surety may have that must be paid in full before there are any distributions to the Debtor's pre-petition general unsecured creditors. One example may be post-petition renewal premiums for commercial surety bonds (license bonds, tax bonds, and others) that are necessary for the Debtor's business operations to continue during the bankruptcy case.

#### B. The Surety's Subrogation Rights to Another's Administrative Expense Claim.

The surety may be subrogated to the administrative expense claim of some obligee (such as a utility bond obligee) that the surety pays under its bond. For example, a commercial surety Debtor – such as a retailer – may establish a fund in the bankruptcy case to pay such utility bills incurred by the Debtor post-petition. If the surety pays the post-petition utility bond claim, the surety may have subrogation rights to the obligee's rights in the fund for reimbursement of the surety's payment.

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<sup>17</sup> The Bankruptcy Court may allow an administrative expense claim for “the actual, necessary costs and expenses of preserving the [debtor's] estate.” Section 503(b)(1)(A) of the Bankruptcy Code.

C. The Surety's Executory Contract Cure and Adequate Protection Claims.

If a Debtor assumes an executory contract bonded by the surety, the Debtor must cure or provide adequate assurance that it will promptly cure all defaults. If the surety has made payments on the bonds for that contract, the Debtor was probably in default of its payment obligations under the bonded contract. The Debtor must cure the defaults by reimbursing the surety for its payments and must provide adequate assurance of future performance to the surety to avoid future defaults before the bonded contract can be assumed or assumed and assigned to another entity.

D. The Surety's Claim for Providing Post-Petition Surety Credit to the Debtor.

Finally, the surety may have post-petition administrative expense claims and possibly secured claims for issuing new surety credit post-petition to the Debtor.

Remember, however, that a surety's post-petition payment for an obligation (Indemnity Agreement or bond) executed pre-petition is NOT provided any post-petition rights or priorities to the assets of the Debtor's bankruptcy estate.