SURETY TODAY PRESENTATION

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Bankruptcy: The Automatic Stay and Property of the Bankruptcy Estate - What They Are and Their Interplay

This is the first in a series of surety/bankruptcy related presentations that George and I will give over the next several months. The Goals for this series are –

1. To provide the general bankruptcy concepts to our attendees.
2. To provide the legal effect of those bankruptcy concepts on the surety and its rights and obligations.
3. To provide the practical approaches and solutions that a surety may consider when faced with its principal's and/or indemnitors' bankruptcy cases.

Today's presentation will focus on the automatic stay and property of the Debtor's bankruptcy estate.

The Automatic Stay

Mike: I am going to start off today with a brief overview of the automatic stay – the who, what, where, why and when if you will. The automatic stay is set forth in the Bankruptcy Code at 11 U.S.C. §362. Once a petition for bankruptcy is filed, in any chapter of bankruptcy – 7, 11, 13, etc., the automatic stay comes in to effect. As its name suggests, the stay arises automatically and immediately by operation of law, no order of the court or issuance of a notice is required to bring it into existence.

Who does the automatic stay apply to. The automatic stay is applicable to all entities and persons. The words "entity" and "person" are defined in the Code very broadly as any person, estate, trust, government, corporation or unincorporated company or association. Thus, courts, governmental agencies like the IRS, banks, and sadly even surety companies are subject to the stay.

There are several well recognized purposes of the automatic stay. The first is to provide relief to the debtor from the pressure and harassment of creditors and to give the debtor a "breathing spell" to focus on rehabilitation or reorganization. The stay also protects property that may be necessary for reorganizing and providing a "fresh start." The stay is intended to promote one of the primary goals of the bankruptcy process which is equality of distribution. It preserves the status quo and prevents the "disorganized dismemberment" of the debtor by creditors chaotically running all over the country to various courthouses to obtain independent relief to the detriment of other creditors and the debtor.

What does the automatic stay apply to? To accomplish the purposes of the bankruptcy process, the scope of the stay has intentionally been made very broad in the Code. It applies to the commencement or continuation of any judicial proceeding or other action or proceeding against the Debtor that was or could have been commenced prior to the filing of bankruptcy. The enforcement of a judgment or lien against the Debtor or against the property of the Debtor's bankruptcy estate that arose prior to the filing of the Debtor's bankruptcy case, including any act to obtain possession of or control over the Debtor's property. It applies to any attempt to create, perfect or enforce any lien against the Debtor's property, which includes the filing of a UCC financing statement. The stay also applies to any act to enforce a setoff right against any debt owed to the Debtor that arose before the bankruptcy case was filed. Regarding the scope of the automatic stay, it has been observed that the stay is extremely broad and applies to almost any type of formal or informal action taken against the Debtor or the property of the estate.

The automatic stay remains in force until property subject to the stay is no longer property of the estate or the earliest of: (i) the time the case is closed; (ii) the time the case is dismissed; or (iii) the time a discharge is granted or denied. The stay may also be lifted by the Bankruptcy Court and I will talk about that a little later.

There are exceptions to the automatic stay. The Code provides that the stay does not apply to criminal actions, paternity suites, domestic support, custody or divorce matters, domestic violence, certain police powers and other limited matters. The stay also may not apply if the debtor has recently filed a bankruptcy case under certain circumstances. The automatic stay does not generally apply to separate related entities of the Debtor who are not in bankruptcy, such as directors, officers, affiliates, partners, etc. However, such entities could seek protection under 11 USC §105 – injunctive relief. Actions on claims that arose after the commencement of a case are not stayed, however enforcement of any resulting judgment would typically be stayed.

If the automatic stay is violated, such action is either void or voidable depending on the nature of the violation. Further, under the Code in the event of a willful violation of the stay an individual may recover actual damages, costs, attorneys' fees and in appropriate circumstances punitive damages. Moreover, a violation of the stay can be punished under the Bankruptcy Court's contempt powers. The Fifth Circuit has held that standing to assert a claim for willful violation of the automatic stay is not limited to the Debtor or trustee and could be asserted by any creditors who have suffered damages because of a violation. *St. Paul Fire & Marine Ins. Co. v. Labuzan*, 579 F.3d 533 (5th Cir. 2009).

Property of the Bankruptcy Estate (Section 541 of the Bankruptcy Code)

George: Because the concept of "property of the Debtor's bankruptcy estate" is so prevalent in the context of what can or can't be done that could result in a surety's violation of the automatic stay, we will address that concept now. Therefore, the first question is: what is the definition of "property of the bankruptcy estate?"

Section 541 of the Bankruptcy Code provides: As of the filing of the bankruptcy case, the Debtor's bankruptcy estate is comprised of all legal or equitable interests of the Debtor in

property as of the commencement of the bankruptcy case, wherever located and by whomever held. Property of the estate includes proceeds or profits of or from property of the bankruptcy estate.

In determining the nature and extent of the Debtor's interest in property and whether that property becomes property of the Debtor's bankruptcy estate, the bankruptcy court must look to the property rights of the Debtor as defined by applicable state law. The Debtor's rights are determined as of the date of the commencement of the bankruptcy case. Section 541 of the Bankruptcy Code does not vest or provide the Debtor's bankruptcy estate with any greater rights than those held by the Debtor. To the extent that the legal or equitable interests in the Debtor's property included in the bankruptcy estate are limited in the Debtor's hands, they are generally limited to the same extent in the hands of any Debtor or any Trustee appointed for the Debtor because the Trustee acquires only the rights that the Debtor has and nothing more. For example, property in which the Debtor holds only legal title and not an equitable interest becomes property of the estate only to the extent of the Debtor's legal title to such property, but not to the extent of any equitable interest in such property that the Debtor does not hold.

The takeaway here is that the Debtor's bankruptcy estate gets no better interest in property after the Debtor's filing of the bankruptcy case than the Debtor had prior to the filing of the bankruptcy case.

From the surety's perspective, what is "property of the bankruptcy estate?" The following are some examples:

1. All real property of the principal/debtor in which the surety may have a lien interest (such as a mortgage or deed of trust).
2. All personal property of the principal/debtor in which the surety may have a lien interest (such as a Security Agreement and filed UCC-1 Financing Statement or the surety's possession of the property as collateral such as cash).
3. All collateral of the principal/debtor of any other kind held by the surety as a result of the execution of the indemnity agreement and/or the surety bonds, whether at the time of the execution of the surety bonds or pursuant to a demand for collateral or place in funds demand under the indemnity agreement.
4. Perhaps, and maybe probably, the Bonded Contract Funds are "property of the bankruptcy estate" – which is an issue that we will address briefly today and more in the December 11 Surety Today presentation.

What may not be property of the Debtor's bankruptcy estate.

1. Letters of Credit and proceeds of a Letter of Credit.
2. The surety's performance and payment bonds – the Debtor has no claim or right to recovery under such bonds.
3. Question: There is the question of whether the Debtor has property rights in the surety's commercial surety bonds that the Debtor requires to maintain its business operations – namely, without certain commercial surety bonds, the Debtor cannot operate its business –

including license bonds, deposit bonds, tax bonds, Importer Bonds with Customs, and hundreds of other examples depending upon the type of the Debtor's business. It is clear that the surety may not cancel such bonds without obtaining relief from the automatic stay.

4. Question: Once again, are the Bonded Contract Funds property of the Debtor's bankruptcy estate? – watch out, they may well be!!!

The Next Issue is the Interplay of the Concepts of the Automatic Stay and Property of the Debtor's Bankruptcy Estate and How They Relate to the Surety

A. We Will Start with a Factual Scenario – The surety writes performance and payment bonds for the contractor/principal, or the commercial surety writes various bonds for the commercial surety customer.

B. The Issue is How and When May the Surety Obtain Collateral from the Principal?

1. **The first instance is prior to the execution of the bonds for the principal**, when the surety obtains collateral from the principal in the form of the principal's real and/or personal property, including cash collateral held by the surety.

OR

2. **The surety may obtain collateral after the surety's execution of the bonds, but prior to the Debtor's filing of the bankruptcy case** (more than 90 days – otherwise the preference issues arise – which is another discussion on another day). Namely:

a. The surety receives claims against the surety bonds; or
b. The surety learns of the principal's dire financial circumstances; and
c. The surety makes a demand under the indemnity agreement for collateral in the form of the principal's real and/or personal property; and
d. The surety obtains the collateral – either cash to hold or other liens on the principal's real and/or personal property.

OR

3. **Finally, the surety may face collateral issues after the Debtor's filing of the bankruptcy case**:

a. In the first instance, the surety may want to obtain collateral from the principal, now the Debtor, after the Debtor's filing of the bankruptcy case, which is a subject for another day; **or, more frequently**,

b. The surety wants to exercise its lien rights and other rights against the collateral that it obtained from the principal prior to the filing of the bankruptcy case (such as the collateral referenced in 1 and 2 above).

C. What Happens to the Surety, the Debtor and the Collateral?

1. Because of the automatic stay, the surety can't commence any action against either the Debtor or the property of the Debtor's bankruptcy estate to either reduce the surety's loss or reimburse the surety for its losses under the surety bonds.

2. The surety can't exercise or enforce its lien rights against the collateral that is property of the Debtor's bankruptcy estate:

a. Cash held in a surety collateral account.
b. Real property subject to the surety's liens.
c. Personal property subject to the surety's liens – such as liens against equipment, inventory, etc.

3. The surety can't obtain new collateral or lien rights from the Debtor after the filing of the Debtor's bankruptcy case without bankruptcy court order under very special circumstances that will be discussed in the December 11 Surety Today presentation.

In summary, the surety will maintain its lien and other rights in the property of the Debtor's bankruptcy estate that serves as the surety's collateral. The surety may be to obtain adequate protection from the Debtor as a result of the Debtor's use of the collateral that the surety is holding, such as the requirement of the Debtor's maintenance of insurance on the real and/or personal property or the Debtor making periodic payments to the first lienholders on that property who have priority over the surety's lien rights. The surety may obtain other rights and some control over the Debtor's use of the Bonded Contract Funds as will be discussed next month.

BUT, the surety may not exercise its indemnity agreement rights or other lien rights under any mortgage or deed of trust on real property or security or collateral agreement rights against personal property to liquidate the property to pay surety bond claims or reimburse the surety for its losses as such actions are a violation of the automatic stay.

Circumstances When the Automatic Stay does not Apply?

A. Letters of Credit

Mike: As George mentioned there is one form of collateral that the surety can hold that is not considered to be property of the bankruptcy estate – namely Letters of Credit. Because letters of credit are not property of the bankruptcy estate, it is generally held that the automatic stay does not apply. Why is a letter of credit not subject to the automatic stay? The reason is because the letter of credit is an agreement between the surety and the bank to which the debtor is technically not a party. A letter of credit is the product of essentially three transactions.

- The first transaction relates to the principal and surety and the issuance of bonds.
- The second transaction relates to the principal and the bank and the request for the issuance of a letter of credit from the bank.
- The third transaction is the bank issuing the letter of credit to the surety with the surety as the beneficiary.

The unique feature of a letter of credit that insulates it from being considered property of the estate is something referred to as the "independence principle."

The independence principle holds that each of the three transactions are deemed to be independent and separate from each other. The issuance of a letter of credit is held to be completely separate and independent from the underlying transaction between the principal and the surety. Thus, the bank, that issues the letter of credit, is pledging its own credit and its own assets to the surety, regardless of what transpires in the underlying transaction between the principal and the surety or between the bank and the principal. The bank is paying out its own money, not the Debtor's money. Because of the independence principle the assets of the bankruptcy estate are deemed not to be involved. Thus, the automatic stay does not apply and the surety is free to draw down on the letter of credit and use the proceeds to reimburse itself or pay claims without violating the automatic stay or seeking permission of the bankruptcy court.

B. Surety Bonds

What about Surety Bonds, are they covered by the automatic stay? The answer is – it depends. There are many cases holding that a bond posted by a surety to secure the obligations of a debtor is not property of the debtor's bankruptcy estate. As a result, because the bond is generally considered not to be property of the estate, the automatic stay does not apply to the surety or the bond in general. Thus, even when the Principal on a bond is in bankruptcy, the obligee or a claimant may assert a claim against a bond or maintain a cause of action against the surety under the bond and the surety is free to make payments under the bonds.

But surety bonds provide a good example of the complexity of the application of the automatic stay. While a bond is not property of the estate and claims can be made against and paid from the bond, cancellation of a bond or renewal of a bond can be covered by the automatic stay, particularly with commercial bonds. Many times commercial bonds, such as license bonds, are required for the commercial principal to remain in business. In these circumstances, many courts will find that the automatic stay applies to such actions. The courts reach this conclusion for a variety of reasons. In some cases, the courts observe that cancellation of bonds is not one of the recognized exceptions to the automatic stay in the Code and that prohibiting cancellation furthers the broad purpose of the stay. One Court noted that while the surety may have the right to cancel its bond, "bringing these kinds of contracts within the ambit of the automatic stay ensures that the legal question of whether a particular contract may be terminated will be decided in the proper forum, after a full briefing by the parties rather than by a nondebtor party acting unilaterally and perhaps erroneously."

Other courts have held that the automatic stay applies because the act of cancelling a bond constitutes a "proceeding" against the Debtor and such action is barred by the stay under the Code. For example, in *In re Wegner Farms Co.*, 49 B.R. 440 (Bankr. N.D. Iowa 1985) the Court addressing a grain dealer license bond, stated:

> Pursuant to Iowa Code, the surety could not legally cancel the bond without giving 60 days' notice by certified mail to the Iowa State Commerce Commission

> and the Debtor. Although this procedure was informal and not judicial in nature, it nonetheless was a proceeding by the surety to forfeit the Debtor out of a valid extant contract. As such, the procedures initiated by the surety to terminate the Debtor's interest in the contract was a proceeding against the Debtor in contravention of section 362(a)(1).

The *Wegner Farms* Court also held that the Debtor, as the principal under the bond had a protected property interest in the bond. The court observed that the bonding agreement was a valid legal contract entered into by the surety and the principal, now the debtor. Even though the payment obligation ran to the third parties doing business with the Debtor as a grain dealer, the Debtor's coverage under the bond was a contractual obligation bargained for by the Debtor and for which it paid valuable consideration. The Court stated:

> "It defies logic to say that the Debtor as the named principal under bond and the payer of the premium for the coverage provided by the bond had no legal or equitable interest in the bonding agreement. Quite the contrary, the Debtor had valid contractual rights in the bonding agreement on the date of filing. Contractual rights constitute intangible property which is included within the definition of property of the estate. Consequently, the surety's unilateral termination of the agreement postpetition was an attempt to obtain possession of property of the estate in contravention of section 362(a)(3)."

As the treatment of letters of credit and bonds demonstrate, if the action will have an impact on the Debtor or the property of the estate, the automatic stay will likely apply.

Are the Bonded Contract Funds Property of the Debtor's Bankruptcy Estate?

George: Because the Bonded Contract Funds may be the only "collateral" that the contract bond surety is entitled to assert an interest in, we will briefly mention the Bonded Contract Funds now.

A. There are Arguments that the Bonded Contract Funds are NOT Property of the Debtor's Bankruptcy Estate.

1. There may be a Debtor default under the Bonded Contract (a default in the performance of the work and/or a default in the payment of the subcontractors and /or suppliers) – and the argument is that the Bonded Contract Funds have not been earned by the Debtor and, therefore, are not property of the Debtor's bankruptcy estate.
2. The Bonded Contract may have been effectively terminated – and the Debtor has no rights to the payment of the Bonded Contract Funds.

B. There are Arguments that the Bonded Contract Funds Become Property of the Debtor's Bankruptcy Estate.

1. The Debtor may still be performing the work and may cure any defaults, and thereby become entitled to the payment of the Bonded Contract Funds in the future.

2. A portion of the Bonded Contract funds may be for the Debtor's own performance of the work and/or overhead and general administrative expenses – not just for the payment of the Debtor's subcontractors and suppliers.

C. The Surety May Have Interests in the Bonded Contract Funds, such as:

1. A security interest; and/or
2. The surety's assertion of its subrogation rights.

D. The Surety May Have Trust Fund Rights to the Bonded Contract Funds.

1. Under state trust fund statutes;
2. Under the trust fund provision of the indemnity agreement; or
3. Under a trust fund provision in the Bonded Contract.

E. The Surety May Send a Notice Letter to the Surety Bond Obligee Concerning the Bonded Contract Funds – But Can It Do So Without Relief from the Automatic Stay?

1. There are Risks.
2. There are Reasons to do so.

The effect of the filing of the Debtor's bankruptcy case on the respective rights of the Debtor and the surety to the Bonded Contract Funds will be the subject of the December 11 Surety Today presentation. We only mention the issues of the treatment of the Bonded Contract Funds here today in order to remind all of us that the Bonded Contract Funds may be deemed to be property of the Debtor's bankruptcy estate, and the surety's rights to the Bonded Contract Funds may be affected by the automatic stay.

Obtaining Relief from the Automatic Stay

Mike: If the automatic stay does apply or if you are not sure if the stay applies or not, but you are concerned about violating the stay, what can you do? The Code at §362(d) provides the means and ability to obtain relief from the automatic stay. The Code provides that "[o]n request of a party in interest and after notice and a hearing, the court shall grant relief from the stay, … such as by terminating, annulling, modifying or conditioning such stay." Under section 362(d)(1) the stay may be lifted or modified for cause, including the lack of adequate protection of an interest in property of such party in interest. Under section 362(d)(2) the stay may be lifted or modified with respect to an act against property of the Debtor's bankruptcy estate, if: (a) The Debtor does not have an equity in such property; and (b) Such property is not necessary to an effective reorganization.

The surety may move for relief from the stay to take control of bonded projects pursuant to the surety's assignment rights under the general indemnity agreement, statutory rights as surety or subrogation rights. Under Section (d)(1) the surety's primary argument is often the principal's financial inability to complete the bonded projects. Most bankruptcies occur because the Debtor has run out of cash and without sufficient cash, the Debtor will not be able to pay for

labor, supplies and materials. Many times projects have been front loaded so that the cost to complete the project is greater than the remaining contract funds. Further, delay costs and/or liquidated damages incurred as a result of the bankruptcy will only make the cost to complete greater. The principal cannot provide adequate protection because it is not able to competently and timely complete the bonded projects.

Under Section (d)(2) the surety can get relief from the stay if it can establish that its losses will exceed the remaining contract funds such that the Debtor has no equity in the contract funds. For purposes of establishing lack of equity all obligations of the Debtor can be combined to determine the Debtor's equity position. It is important to note that the burden will be on the surety to establish entitlement to relief from the stay. In several of my recent bankruptcy cases we were able to convince the Trustee that the Debtor had no equity in the open projects and we filed a stipulation allowing the Debtor to be terminated from the project and the surety to use the contract funds to complete the projects.

Claims Against the Surety Bonds and the Automatic Stay

George: The next issue is how the automatic stay affects any claims by the obligees or other third-party claimants against the surety bonds, whether they are performance and payment bonds or commercial surety bonds.

A. REMEMBER: The Principal/Debtor and the Surety are Jointly and Severally Liable Under the Surety Bonds. The result of this is that:

1. Any action against the Debtor (on the Bonded Contract or the surety bond) is stayed by the automatic stay.
2. But, since the surety is severally liable under the surety bond, any action against the surety alone is not stayed by the automatic stay.

B. Therefore, from the perspective of an Obligee or Third-Party Claimant, Are They Subject to the Automatic Stay When They Attempt to Make a Claim Against a Surety Bond?

1. Against the Principal/Debtor – the answer is YES.
2. Against the surety – the answer is NO.

C. May the Debtor Attempt to Stay Any Actions or Claims Against a Surety Bond?

1. The Debtor's grounds (the Debtor is too busy, especially early on in the bankruptcy case, and is unable to assist the surety in the defense of the claims, or other unusual circumstances).
2. The surety's position.
   a. The lack of help or assistance from the Debtor in defending the claim or action may entice the surety to join with the Debtor to attempt to stay actions against the surety bonds.

b. However, many sureties don't want to have the automatic stay applied to claims against the surety bonds because of the surety's good faith duty to honor its surety bond obligations.

3. The cases go both ways on whether either the automatic stay extends to staying actions and claims against the surety bonds, or whether the bankruptcy court may extend the stay to the surety under its general powers to control the Debtor's bankruptcy case.

4. However, the circumstances under which a bankruptcy court may extend the stay to the surety to prevent surety bond claims are unique and rare.

D. The Surety's Settling and Paying Surety Bond Claims.

1. The indemnity agreement normally provides that a surety may settle any claims, in good faith, against the surety bonds.

2. The surety is not prevented by the automatic stay from settling surety bond claims.

3. The Debtor's "defense" to any such settlement is to object to the surety's proof of claim for the losses that the surety has paid, and challenge either or both of the propriety of the surety's payment and/or the amount of the surety's payment to resolve the surety bond claims.

4. When the surety is holding collateral, especially in commercial surety bond situations, it may want to consult with the operating Debtor and its counsel prior to making any payments to head off, if possible, subsequent objections to the propriety and amounts of the surety's payments.

5. State law should support the surety's rights under the indemnity agreement for its payments made in good faith.

E. Finally, the Surety's Settling the Principal/Debtor's Affirmative Claims.

1. A surety normally is interested in settling its principal's affirmative claims against the obligee when the obligee's performance bond claim against the surety is greater than the principal's affirmative claims, and the surety may reduce its performance bond liabilities to the obligee by resolving the principal's affirmative claims at the same time it resolves and settles the obligee's performance bond claim.

2. The indemnity agreement assignment and power of attorney provisions are normally the basis for the surety's right to settle the principal's affirmative claims against the obligee.

3. Bankruptcy courts have recognized the surety's rights to settle the principal's affirmative claims against the obligee.