NINETEENTH ANNUAL NORTHEAST SURETY AND FIDELITY CLAIMS CONFERENCE

SEPTEMBER 18th and 19th, 2008

THE SURETY'S PROOF OF CLAIM - OBTAINING REIMBURSEMENT FOR THE LOSS

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A major concept of the Bankruptcy Code is that the debtor's creditors will share in the distribution of the debtor's property from the debtor's estate. Whether a trustee is appointed under a chapter 7 to collect and distribute the debtor's property to the debtor's creditors, a chapter 11 debtor acts as a debtor-in-possession and confirms a plan of reorganization that requires certain payments to the debtor's creditors, or a chapter 13 debtor confirms his or her (or their) plan to pay creditors from certain property and future income, some of the debtor's property will be distributed to the debtor's creditors. However, in order for the surety or fidelity insurer to obtain such a distribution in reimbursement of a portion of a loss, they must file a proof of claim in the debtor's bankruptcy case.

This paper will address the surety's and the fidelity insurer's proof of claim in a debtor's bankruptcy case. It will describe the claims that may arise and address the claims administration process. At that point, the proofs of claim that a surety may file in a contract surety or a commercial surety debtor's bankruptcy case not only differ from each other, but differ greatly from a proof of claim that a fidelity insurer may file in a fidelity principal's bankruptcy case. Therefore, the contract surety's and the commercial surety's proofs of claim will be discussed together, with their differences highlighted, and the fidelity insurer's proof of claim against a fidelity principal will be discussed separately.

I. WHAT IS A "CLAIM" FOR THE PURPOSES OF THE PROOF OF CLAIM?

In the event that the surety or fidelity insurer has incurred or may, in the future, incur a loss under its bond or bonds, or the surety has a loss under the indemnity agreement, the surety or fidelity insurer becomes a "creditor" of the debtor to the extent that the surety or fidelity insurer has a "claim" against the debtor that arose at the time of or before the order for relief concerning the debtor (the date of the principal's filing of its bankruptcy petition).[1] The Bankruptcy Code defines a "claim"[2] 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; or

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[1] 11 U.S.C. §101(10).

[2] 11 U.S.C. §101(5).

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

The Bankruptcy Code definition of "claim" is extremely broad and extends to practically every claim that a surety or fidelity insurer may have against the debtor, even if the claim is totally contingent and may never become an actual loss for the surety or fidelity insurer.[3]

1. Contract Surety and Commercial Surety Claims - Generally.

When a contract surety suffers losses under its bonds or pursuant to the terms of an indemnity agreement, the surety will seek to obtain reimbursement for that loss, whether the loss is a payment under its performance or payment bonds or for attorneys' fees, consultants' fees and other costs and expenses. The contract surety has a number of avenues to review in seeking to obtain reimbursement. It may pursue its principal under a common-law claim for reimbursement and/or indemnity as a result of the execution of the bond,[4] it may pursue its principal and indemnitors under an indemnity agreement, it may pursue its own rights against the obligee or others, and/or it may enforce its subrogation rights to pursue the rights of others.[5]

Unlike the contract surety writing performance and payment bonds in favor of its principal/contractor involved in construction contracts with the obligees, the commercial surety providing commercial surety bonds for its principal to an obligee rarely, if ever, finds the obligee holding funds or monies available for the commercial surety's reimbursement in the event that it must make a payment under its commercial surety bonds. Rather, a commercial surety bond is generally written for a "solvent" principal who requires the commercial surety bond for its business or litigation purposes. Therefore, when the commercial surety incurs a loss under a commercial surety bond, its most likely source for reimbursement is from its

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[3] A surety that incurs no loss and has no claims may have most if not all of its rights under the indemnity agreement discharged in the debtor's bankruptcy case. *See e.g., Williams v. U.S. Fidelity & Guaranty Co.*, 236 U.S. 549 (1915); *In re Butt*, 68 B.R. 1001 (Bankr. C.D. Ill. 1987); *In re Rayson*, 39 B.R. 597 (Bankr. C.D. Cal. 984); *In re Meile*, 36 B.R. 719 (Bankr. S.D. Ill. 1984).

[4] 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, 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.

[5] A number of books and many papers and articles have described the surety's rights to pursue its claims for reimbursement and/or indemnity and its other rights, including its subrogation rights. *See* THE SURETY'S INDEMNITY AGREEMENT – LAW & PRACTICE, 2D ED. (Marilyn Klinger, George J. Bachrach and Tracey L. Haley eds., 2008) (and the books, papers and articles cited therein); George J. Bachrach and John V. Burch, *The Surety's Subrogation Rights, in* THE LAW OF SURETYSHIP, 2D ED. 419-53 (Edward G. Gallagher ed., 2000) (and the books, papers and articles cited therein); George J. Bachrach and Cynthia E. Rodgers-Waire, *The Surety's Rights to the Contract Funds in the Principal's Chapter 11 Bankruptcy Case,* 35 TORT & INS. L.J. 1 (1999); George J. Bachrach, *The Surety's Rights to Obtain Salvage – Exoneration, Reimbursement, Subrogation and Contribution, in* SALVAGE BY THE SURETY (George J. Bachrach ed., 1998) (and the books, papers and articles cited therein); THE SUBROGATION DATABASE: CASES CONCERNING THE SUBROGATION RIGHTS OF THE CONTRACT BOND SURETY (George J. Bachrach ed., 1995) (and the books, papers and articles cited therein).

principal and indemnitors under the indemnity agreement and not the commercial surety's exercising of its own rights against the obligee, if any exist, or its subrogation rights to pursue the rights of others.

In the bankruptcy context, there are a number of scenarios under which the contract surety or the commercial surety may have a reimbursement claim against the principal, which is now a debtor under chapter 7 or chapter 13 or debtor-in-possession under chapter 11 of the Bankruptcy Code.[6] The scenarios include:[7]

1. The principal and the indemnitors have executed an indemnity agreement prior to the principal's filing of its bankruptcy petition (the "pre-petition" period), and all of the contract or commercial surety bonds have been executed pre-petition;

2. The surety has made payments to the obligees and/or other claimants as a result of losses incurred under the pre-petition contract or commercial surety bonds, and the payments have been made during the pre-petition period;

3. The surety has made payments to the obligees and/or other claimants as a result of losses incurred under the pre-petition contract or commercial surety bonds, and the payments have been made after the principal's filing of its bankruptcy petition (the "post-petition" period), or the payments have been made both during and after the principal's filing of its bankruptcy petition; and

4. The surety and the debtor have executed post-petition contract or commercial surety bonds and the surety has made post-petition payments to the obligees and/or other claimants as a result of losses incurred under the post-petition contract or commercial surety bonds.

This paper will focus on the first three scenarios, and will not discuss the post-petition administrative expense claim that a surety would have against the debtor in the event that the surety seeks reimbursement for its post-petition payments and loss as a result of executing post-petition contract or commercial surety bonds. With respect to a surety's claim against its principal, now a debtor, in the debtor's bankruptcy case, when the contract or commercial surety bonds are executed pre-petition and whether the surety's payments on those pre-petition bonds are made pre-petition, post-petition, or both, the surety is seeking to enforce its common-law reimbursement rights against the debtor as well as its rights under the surety's indemnity agreement.

[6] This paper will use the term "principal" to refer to the entity executing the contract or commercial surety bond with the surety prior to the principal's filing of its bankruptcy petition. Even though the principal remains a principal under the contract or commercial surety bond after the filing of its bankruptcy petition, the principal will be referred to as the "debtor" rather than the principal after the principal files its bankruptcy petition and becomes a debtor.

[7] As of the date of the filing of its bankruptcy petition, the principal becomes a debtor or debtor-in-possession under the Bankruptcy Code. All of the principal's actions, rights and obligations, and any other events that occur prior to the principal's filing of its bankruptcy petition are known as "pre-petition" actions, rights, obligations and events. All of the principal's, now the debtor's, actions, rights and obligations, and any other events that occur after the principal's filing of its bankruptcy petition are known as "post-petition" actions, rights, obligations and events.

2. Fidelity Insurer Claims - Generally

For the fidelity insurer that incurs a loss as a result of its payment of the insured's claim, the fidelity insurer has a claim against the fidelity principal, the wrongdoer.[8] This claim is not based upon any written agreement between the fidelity insurer and the fidelity principal. The fidelity insurer's "claim" against the fidelity principal is based upon a number of rights that the fidelity insurer has, including its subrogation and assignment rights as well as its common-law rights against the fidelity principal.

There is really only one scenario with respect to a fidelity insurer's claim against a fidelity principal and that is when the actions of the fidelity principal that caused a loss to the fidelity insurer occur pre-petition (prior to the fidelity principal filing its bankruptcy petition).[9] Until the fidelity principal's activities are discovered, the fidelity principal is unlikely to file a bankruptcy petition. Furthermore, a fidelity principal would not be discharged from any actions causing loss to a fidelity insurer that occur post-petition and result in a loss to the fidelity insurer. Most fidelity principals file their bankruptcy petitions after a discovery of their actions resulting in a loss to the fidelity insurer, and the fidelity insurer will have a pre-petition claim against the fidelity principal in their bankruptcy case regardless of whether the ultimate payment and loss is incurred pre-petition or post-petition.

II. THE CLAIMS ADMINISTRATION PROCESS

To participate in any distributions to pre-petition unsecured creditors of the debtor as a result of the surety's or fidelity insurer's claim arising from the execution of the bond or bonds, and to realize on any collateral to the extent that the surety's claim is secured by that collateral, the surety or the fidelity insurer must file a proof of claim.[10] The proof of claim is a written statement setting forth a creditor's claim and shall conform substantially to the appropriate official form of the proof of claim.[11] For the purposes of this section II of the paper, any references to the "surety" shall also apply to the fidelity insurer.

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[8] A fidelity insurer may have a right against its fidelity principal and others as a result of its payment of an insured's claim. Among the more recent publications that discuss salvage and reimbursement by a fidelity insurer, the following are examples: (1) Karen K. Fitzgerald, *Salvage and Recovery, in* COMMERCIAL CRIME POLICY, 2D ED. 535 (Randall I. Marmor & John J. Tomaine eds., 2005) (hereafter "Fitzgerald"); (2) Michael R. Davisson and Susan Koehler Sullivan, *Subrogation and Mitigation, in* HANDLING FIDELITY BOND CLAIMS, 2D ED. 611 (Michael Keeley & Sean Duffy eds., 2005) (hereinafter "Davisson and Sullivan"); (3) Robert J. Berens and Tracey L. Haley, *Bankruptcy: From the Insurer's Point of View, in* HANDLING FIDELITY BOND CLAIMS, 2D ED. 661 (Michael Keeley & Sean Duffy eds., 2005) (hereinafter "Berens and Haley"); and (4) James A. Knox, Jr., *Salvage, in* FINANCIAL INSTITUTION BONDS, 2D ED. 501 (Duncan L. Clore ed., 1998) (hereafter "Knox").

[9] Even though the fidelity principal remains a fidelity principal after the filing of its bankruptcy petition, the fidelity principal will also be referred to as the "debtor" rather than the fidelity principal after filing its bankruptcy petition and becoming a debtor.

[10] 11 U.S.C. § 501. Bankruptcy Rules 3001, 3002(a) and/or 3003.

[11] Bankruptcy Rule 3001(a).

The claims administration process for the debtor is spelled out in much greater detail in other publications,[12] and will only be generally described in this paper. The claims administration process includes the surety's filing of its proof of claim on a timely basis whether the claim is a secured claim, a general unsecured claim, or a priority unsecured claim, and whether the surety's claim is liquidated, unliquidated, contingent, non-contingent, disputed or undisputed. The proof of claim must state the basis for the surety's claim, the type of claim or claims being asserted by the surety, and the amount of the claim.[13] The proof of claim shall conform substantially to the appropriate Official Form for the particular proof of claim.[14]

In order for the surety's proof of claim to become an allowed claim, the proof of claim must be filed timely in accordance with the Bankruptcy Code and the Bankruptcy Rules. In a chapter 7 liquidation or a chapter 13 individual's debt adjustment case, the surety's proof of claim is filed timely if it is filed not later than 90 days after the first date set for the meeting of creditors under section 341(a) of the Bankruptcy Code.[15] In a chapter 11 reorganization case, the proof of claim must be filed within the time limit set by the Bankruptcy Court (the "Bar Date").[16] In a chapter 11 case, the court may set the Bar Date in the notice of the meeting of creditors under section 341 of the Bankruptcy Code, and proofs of claim must be filed within 90 days of the meeting of creditors unless otherwise extended by the court.[17] In larger chapter 11 bankruptcy cases, the debtor may request the establishment of a specific Bar Date and notice of the Bar Date will be sent to all creditors who have requested notice.

PRACTICE POINTER: The surety may file a notice of appearance and request for service of notices and papers pursuant to 11 U.S.C. §§ 102(1) and 342, and Bankruptcy Rules 2002, 3017, 3020, 4001 and 9007 in order to receive all notices and papers filed in the debtor's bankruptcy case. If the surety receives the debtor's first notice of the meeting of creditors, this means that the surety has been listed as one of the debtor's

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[12] *See* Joanne S. Brooks and Robert F. Carney, *The Impact of the Bankruptcy Code on the Surety's Pursuit of Salvage, in* SALVAGE BY THE SURETY (George J. Bachrach ed., 1998); Robert F. Carney, *The Impact of the Bankruptcy Code on the Surety's Pursuit of Salvage* (unpublished paper submitted at the Sixteenth Annual Northeast Surety and Fidelity Claims Conference on September 22, 2005).

[13] *Id. See also* THE SURETY'S INDEMNITY AGREEMENT - LAW & PRACTICE, 2D ED. 480-81 (Marilyn Klinger, George J. Bachrach and Tracey L. Haley eds., 2008).

[14] Bankruptcy Rule 3001(a).

[15] Bankruptcy Rule 3002(c). In a no-asset chapter 7 case, the notice of the meeting of creditors may provide that it is unnecessary for creditors to file proofs of claim. If assets are subsequently discovered, a further notice will be sent to the creditors providing directions as to the need for filing proofs of claim and when the proofs of claim must be filed. Bankruptcy Rules 2002(e) and 3002(c)(5). If the surety receives the first notice of the meeting of creditors stating that the case is a no-asset chapter 7 case, the surety should receive the second notice to creditors directing them to file a proof of claim in the case if and/or when assets have been discovered. If, however, the surety does not get the first notice, and then subsequently learns about the debtor's bankruptcy case through other sources, the surety will not automatically receive the second notice because it is not on the debtor's list of creditors. Any surety or fidelity insurer that learns about a debtor's bankruptcy case from a source other than from the debtor's filings and/or the bankruptcy court should file a notice of appearance and request for service of notices and papers pursuant to 11 U.S.C. §§ 102(1) and 342 and Bankruptcy Rules 2002, 3017, 3020, 4001 and 9007 in order to receive all notices and papers filed in the debtor's bankruptcy case.

[16] Bankruptcy Rule 3003(c)(3).

[17] *Id.*

creditors. If, however, the surety learns of the debtor's bankruptcy case from a source other than the debtor's filings and/or the bankruptcy court, the surety should file a notice of appearance and request for service of notices and papers in order to obtain relevant information from the debtor and the bankruptcy court. Sometimes the papers received are overwhelming in number and bulk. However, the surety will receive notice of the proof of claim Bar Date. Furthermore, the surety may routinely obtain a copy of the bankruptcy case docket sheet through electronic means and may contact the debtor's counsel for additional information.

The Bankruptcy Code and the Bankruptcy Rules provide another means for the surety's claim to become allowed under a chapter 11 bankruptcy case. If a chapter 11 debtor lists the surety's claim in its schedules in the correct amount and does not list the claim as disputed, unliquidated or contingent, the surety's scheduled claim is prima facie evidence of the validity and the amount of the surety's claim and the surety does not need to file a proof of claim.[18] However, this rarely, if ever, occurs with respect to a contract or commercial surety or a fidelity insurer because their losses are never undisputed, liquidated and non-contingent as of the date of the principal's filing of the bankruptcy petition. Therefore, the surety must expect that it will be required to file a timely proof of claim.[19]

PRACTICE POINTER: While the Bankruptcy Code provides that the surety "may" file a proof of claim in some circumstances, in reality the surety must file a proof of claim unless the case is a no-asset chapter 7 case.[20] The surety's claim is rarely listed in the debtor's schedules, and, when it is listed, the surety's claim is always listed as disputed, contingent and unliquidated. The surety with an unsecured claim must always file a timely proof of claim.[21]

After the surety's proof of claim is executed and filed, the proof of claim is considered prima facie evidence of the validity and the amount of the claim,[22] and the surety's claim is deemed allowed unless a party in interest objects to the surety's proof of claim.[23]

III. THE CONTRACT OR COMMERCIAL SURETY PROOF OF CLAIM

The claims administration mechanics and procedures for filing a proof of claim are set forth in the Bankruptcy Code and the Bankruptcy Rules. One basis for the surety's claim is the

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18 11 U.S.C. § 1111(a). Bankruptcy Rules 3003(b)(1) and 3003(c)(2).

19 Bankruptcy Rule 3003(c)(2) (any creditor whose claim is not scheduled or scheduled as disputed, contingent, or unliquidated, shall file a proof of claim within the time prescribed by the Bankruptcy Rules, and a failure to do so will disqualify the creditor from voting and a distribution under any chapter 11 plan) and Bankruptcy Rule 3003(c)(4) (the surety's filed proof of claim supersedes any claim scheduled by the debtor for the surety).

20 Bankruptcy Rule 2002(e).

21 Bankruptcy Rule 3002(a), which provides that an "unsecured creditor . . . must file a proof of claim . . . for the claim . . . to be allowed."

22 Bankruptcy Rule 3001(f).

23 11 U.S.C. § 502(a). Bankruptcy Rule 3007.

surety's common-law rights of indemnity and reimbursement from its principal. A second basis for the surety's claim is its contractual rights under the indemnity agreement and any other written agreements with the principal and the indemnitors. A third basis for the surety's claim is the surety's subrogation rights, including the contract surety's subrogation rights to any bonded contract funds. The surety has a number of claims under the indemnity agreement and any other written agreements[24] against the debtor as described below.

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

The surety may have a contractual secured claim because it has obtained a letter of credit from the principal and/or perfected the surety's rights in the principal's collateral security, including the principal's real and personal property, either contemporaneously with the execution of the indemnity agreement and/or the bonds or sometime thereafter.[25] The following are examples of when the surety's lien rights[26] in certain collateral security may provide the surety with a secured claim against the debtor and/or the debtor's real and personal property under section 506 of the Bankruptcy Code.

(a) The surety may have received a letter of credit from the principal's bank as collateral security for the contract (rare) or commercial surety bonds. The proceeds of the letter of credit are not property of the debtor's estate, and the surety is not prevented from drawing on the letter of credit because of the principal's filing of its bankruptcy petition. The surety may draw on the letter of credit in accordance with the terms of the letter of credit and any separate collateral or letter of credit agreement that it may have with the principal/debtor, and use the proceeds to either pay the claims made against the contract or commercial surety bonds or to reimburse the surety.

(b) Prior to or even after the surety's execution of the bonds, the surety may have obtained separate mortgages and deeds of trust against the principal's real property and

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[24] In the contract and commercial surety context, the written agreements between the surety and the principal may include one or more of an indemnity agreement, a collateral agreement, mortgages and/or deeds of trust on real estate, security agreements and financing statements on personal property, letter of credit agreements and the letters of credits themselves, and any other written agreements that provide protection to the surety. While each of these written agreements are different, providing additional and different rights to the surety, for the purposes of this paper those additional written agreements will be lumped together under the reference to the "indemnity agreement."

[25] The timing of the surety's execution of the bonds and its obtaining of the collateral security will determine whether the surety has received a preferential or fraudulent transfer from the debtor that may be avoided by the debtor or others under section 547 or section 548 of the Bankruptcy Code. If the debtor or others believe that the surety has received a voidable preference or fraudulent transfer, an action may be brought against the surety in order to require the surety to pay back the voidable preference or fraudulent transfer into the debtor's estate. To the extent that the surety may be liable to the debtor's estate as a result of a preferential or fraudulent transfer, the court may disallow the surety's proof of claim pursuant to 11 U.S.C. § 502(d) "unless such entity or transferee has paid the amount, or paid over any such property, for which such entity or transferee is liable" for such avoidable transfer under the Bankruptcy Code.

[26] 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 interest in the debtor's property to secure the payment of a debt owed to the surety may give rise to a secured claim.

security agreements and financing statements providing perfected security interests in the principal's personal property.[27]

(c) The surety may have filed a notice (a UCC-1 form) of its indemnity agreement as a financing statement and obtained a perfected security interest in certain assets of the principal, including but not limited to all rights in the principal's causes of action and claims, and any other of the principal's assets that may be subject to the surety's security interest under the indemnity agreement.

(d) The surety may have established a reserve and demanded collateral security under the indemnity agreement, and may be holding the collateral security in its possession, including cash, which provides the surety with a perfected security interest in the collateral security.

(e) The surety may have obtained a judgment against the principal under the indemnity agreement and recorded that judgment under state law as a lien against certain real property of the principal and/or exercised its rights of execution, attachment and garnishment against certain personal property of the principal.[28]

(f) The surety may have certain setoff claims against the principal as a result of money that may be owed by the surety to the principal, such as monies owed by the surety under an insurance policy, a fidelity or surety bond, the return of unearned premiums, or any other claim by the principal against the surety.

(g) The surety may have applicable trust fund rights under the indemnity agreement.[29] Most contract surety indemnity agreements have a trust fund provision that gives the surety trust fund rights as a beneficiary with respect to the bonded and, at times, non-bonded contract funds. Furthermore, some commercial surety indemnity agreements also have a trust fund provision although, for most commercial surety bonds, there is no trust *res* to which the indemnity agreement trust fund rights may attach.

(h) The surety may be secured by its subrogation rights to the rights of others, including the surety's subrogation rights against third parties,[30] rights against collateral held by the bond obligee, and statutory lien rights.[31] In the contract surety case, the surety that performs under its performance and/or payment bonds may have rights against the remaining

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[27] 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.

[28] 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."

[29] *See In re Alcon Demolition, Inc.*, 204 B.R. 440 (Bankr. D.N.J. 1997).

[30] *See* note 5, *supra*.

[31] The term "statutory lien" is defined in 11 U.S.C. § 101 (53) and does not include a "security interest" or a "judicial lien."

bonded contract funds held by obligee. Rarely is a commercial surety bond obligee holding funds to which a surety may claim subrogation rights.

PRACTICE POINTER: The surety's proof of claim for its secured claim[32] should:

1. Describe the surety's liens and security interests in the debtor's property and attach all evidence and documents concerning the surety's liens and security interests;

2. Describe 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 judgment lien to any of the debtor's real or personal property;

3. Reserve any and all rights the surety has with any respect to any setoffs that the surety may have against the debtor and any claims of the debtor; and

4. Specifically describe and reserve its subrogation rights to any rights against or assets of the debtor and to the rights of others to deny the discharge of the debtor or the dischargeability of any debt owed by the debtor.

The surety's rights as a secured creditor against the debtor's property are governed by section 506 of the Bankruptcy Code.[33] The surety's allowed secured claim is secured by a lien on the property to the extent of the value of the surety's interest in the bankruptcy 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 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 (*i.e.,* 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.[34]

There are two variables to any creditor's secured claim - the amount of the claim and the value of the collateral securing the claim. Frequently, a lender will know the value of its claim (principal, interest, costs and fees), but may not know the value of the collateral securing the claim. In other instances, the collateral is cash with a set and known value, but the amount of the claim may be unknown or uncertain. The surety frequently finds that both the amount of

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[32] 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 in the debtor's estate, and fails to file a proof of claim, that lien will remain even if the surety fails to file a proof of claim. It is not recommended that the surety fail to file a proof of claim.

[33] 11 U.S.C. § 506.

[34] 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."

its claim[35] (contract and/or commercial surety bond payments, reserves and other losses under its indemnity agreement, as well as the surety's contingent and unliquidated liabilities up to the penal sums of all of its contract and commercial surety bonds) and the value of its collateral[36] (the value and extent of the surety's liens on real and personal property) are variable. The surety should file its proof of claim as a secured claim notwithstanding the potential unliquidated and/or contingent nature of the surety's claim. The surety's lien on the debtor's real and personal property will continue notwithstanding the fact that the surety's reimbursement claim is contingent and unliquidated[37] and subsequently may be disallowed under section 502(e) of the Bankruptcy Code.

Once the surety's claim is eventually liquidated in amount, including all of its contract and/or commercial surety bond payments, interest on its payments, and payments to its attorneys, consultants and others, the surety's rights to reimbursement from the collateral are affected by section 506(b) of the Bankruptcy Code.[38] Under section 506(b) of the Bankruptcy Code, the surety is entitled to reimbursement as a secured creditor from its collateral to the extent of its allowed secured claim, including all of its losses, interest and other reasonable fees, costs, charges or expenses as provided in the indemnity agreement, but only to the extent that the debtor's estate's interest in the collateral is sufficient to pay the losses, interest and other expenses. To the extent that any interest accrues and/or expenses are incurred prior to the date of the filing of the debtor's bankruptcy case, but the collateral is not sufficient to pay the interest and/or expenses in full, the interest and the expenses not reimbursed from the proceeds of the collateral become a part of the surety's pre-petition general unsecured claim against the debtor. To the extent that the interest accrues post-petition and the expenses are incurred post-petition, the surety is entitled to make a claim for the interest and expenses as part of its secured claim, but may not be allowed the post-petition interest and/or the post-petition expenses as a pre-petition general unsecured claim in the event that the collateral is not sufficient to reimburse the surety for its post-petition accrued interest or incurred expenses.[39]

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[35] 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."

[36] 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."

[37] Pursuant to 11 U.S.C. § 502(e), a contingent claim for reimbursement may be disallowed. However, pursuant to 11 U.S.C. § 506(d)(1), a lien securing a claim against the debtor that is not an allowed secured claim is not void if the claim is disallowed as contingent under 11 U.S.C. § 502(e).

[38] 11 U.S.C. § 506(b).

[39] Many indemnity agreements provide that the surety is entitled to indemnification and reimbursement for any and all losses that the surety incurs, including attorneys' fees and expenses, under a number of circumstances, including having executed or procured the execution of one or more bonds, in taking any steps it may deem necessary in making any investigation or in defending or prosecuting any actions, suits or other proceedings which may be brought under or in connection with the bonds, in recovering or attempting to recover salvage, in obtaining or attempting to obtain release from liability under the bonds, and/or in enforcing any of the terms of the indemnity agreement.

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

Assuming that the surety does not have a lien on any property of the principal, the surety's claim may be a general unsecured claim against the debtor. As stated previously, the surety must file a proof of claim for the amount of its pre-petition losses, interest and expenses. Those pre-petition losses, interest and expenses may be pre-petition in nature even if they are incurred or paid post-petition.[40] However, the surety may or may not be able

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As a general statement of the law, the RESTATEMENT OF THE LAW (THIRD), SURETYSHIP AND GUARANTY, Section 23(1), provides that the debtor has a common-law duty to reimburse the surety for any payments made under a bond, "including incidental expenses." Comment *a.* to Section 23 provides:

> The secondary obligor's reasonable cost of performance also includes (1) reasonable expenses incurred in seeking to determine the existence of any defenses, (2) reasonable expenses incurred in asserting (whether or not successfully) colorable defenses of the principal obligor available to the secondary obligor in a suit by the obligee to enforce the secondary obligation, after the principal obligor has been given notice and opportunity to defend, and (3) any other incidental expenses reasonably incurred by the secondary obligor in connection with performing the secondary obligation. These incidental expenses may include reasonable attorneys' fees incurred in conjunction with performance of the secondary obligation.

The bankruptcy court may limit recovery of the surety's attorneys' fees to pre-petition fees and not to post-petition fees for efforts to preserve and assert salvage rights. Comment *a.* of Section 23 of the RESTATEMENT OF THE LAW (THIRD), SURETYSHIP AND GUARANTY, also provides:

> Attorneys' fees incurred by the secondary obligor to enforce the principal obligor's duty of reimbursement, however, are not recoverable as incidental expenses. Recovery of those fees, as well as the ability of the secondary obligor to recover prejudgment interest, is determined by the law of the applicable jurisdiction.

Travelers Casualty Ins. Co. v. Pacific Gas & Electric Co., 127 S.Ct. 1199 (2007) did not decide the issue of whether the surety's unsecured claim for post-petition attorneys' fees could become part of the surety's pre-petition proof of claim under the indemnity agreement. Since the decision in the *Travelers* case, there have been additional decisions by the bankruptcy courts and on appeal that support the surety claim for post-petition attorneys' fees as part of its pre-petition proof of claim and cases which find against the surety. For example, *see In re Agway, Inc.*, 2008 WL 2827439 (Bankr. N.D.N.Y. July 18, 2008). The court decided the issue of whether an unsecured creditor with a contractual right to recover attorneys' fees could include attorneys' fees incurred post-petition in its allowed pre-petition proof of claim. While recognizing a split of authority (and citing the cases), the court concluded that the surety's allowed claim should include its attorneys' fees incurred post-petition. The attorneys' fees were a contingent claim pre-petition that became a fixed and liquidated claim upon payment post-petition. *See also* THE SURETY'S INDEMNITY AGREEMENT - LAW & PRACTICE, 2D ED. 485-88 (Marilyn Klinger, George J. Bachrach and Tracey L. Haley eds., 2008).

[40] 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.

to include such post-petition accrued interest[41] and incurred and paid expenses as part of its pre-petition general unsecured claim.[42]

PRACTICE POINTER: To the extent that the surety has paid any losses under its bonds and/or any expenses, the surety should file a liquidated, non-contingent, undisputed claim for the amount of its loss, including expenses.

The surety's proof of 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 as described below. In determining the amount of the surety's claim, the surety should ignore all other possible sources of recovery, including any recoveries against any non-debtor principals or indemnitors and any third parties. The surety should include in its liquidated, non-contingent and undisputed claim all of the surety's paid losses, including fees and expenses, and any unpaid premiums.

PRACTICE POINTER: 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).

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

A creditor with an unsecured claim may have priority over other general unsecured claims pursuant to sections 503 and 507 of the Bankruptcy Code.[43] Section 507 of the Bankruptcy Code sets forth certain specific claims that have priority over other general unsecured claims, including the priorities listed in section 507(a)(3) through (10).[44] The indemnity agreement does not assign to the surety any of the rights of a creditor asserting a priority unsecured claim. Furthermore, under section 507(d) of the Bankruptcy Code, the surety is not subrogated to the priority rights of a creditor in the event that the surety pays the claim of the creditor that would otherwise have priority rights as part of the surety's bond obligations.[45]

See also 11 U.S.C. § 501(d).

[41] *See* 11 U.S.C. § 502(b)(2), which disallows claims for "unmatured interest."

[42] *See* note 39, *supra*.

[43] 11 U.S.C. §§ 503 and 507.

[44] The priorities listed in section 507(a)(3) through (10) of the Bankruptcy Code concern priorities for such items as wages, salaries or commissions, various contributions to employee benefit plans, various taxes and other claims of governmental units, and other claims supported by special interests or public policy. Depending upon the language of the surety's bond, the surety may be liable for the payment of some of the priority claims.

[45] 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.

There are only two instances in which the surety may become subrogated to the priority rights of a creditor. The surety may pay a claim, receive an assignment of a paid claim or be subrogated to a paid claim that is considered a priority claim under section 507(a)(2) [administrative expenses allowed under section 503(b) of the Bankruptcy Code] or under section 507(a)(3) [unsecured claims allowed under section 502(f) of the Bankruptcy Code with respect to an involuntary bankruptcy case]. In either instance, it is more likely that the surety's claim will arise pursuant to its subrogation rights or some other rights[46] rather than its rights under the indemnity agreement.

PRACTICE POINTER: 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 has the right to establish a reserve to cover any possible claim, demand, liability, suit, order, judgment, loss or other expense for which the principal, now the debtor, and the indemnitors may be obligated to indemnify the surety under the terms of the indemnity agreement. To the extent that the principal has paid or provided collateral security to the surety to secure the surety against liability or loss, the surety would have a secured claim against the collateral. However, 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 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.[47]

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

A portion of the surety's secured claim and/or general unsecured claim may be contingent and unliquidated. Specifically, while the surety may have a liquidated claim for all of its paid losses and expenses, it will have a contingent and unliquidated liability for the remaining amounts of the penal sums of the bonds that are outstanding as of the date of the filing of the principal's bankruptcy case. The surety's contingent liability is a "claim" under the Bankruptcy Code.[48] The surety must calculate its contingent and unliquidated exposure in order to assert its contingent claim under the indemnity agreement against the debtor.[49]

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[46] In the event that the debtor has the ability or right to assume a contract or a commercial surety bond, any payments subsequently made by the surety may be administrative expenses allowed under section 503(b) of the Bankruptcy Code that have priority under section 507(a)(2) of the Bankruptcy Code.

[47] *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).

[48] 11 U.S.C. § 101(5).

The major concern for the surety is that its contingent claim for reimbursement may be disallowed. Under section 502(e)(1) of the Bankruptcy Code, "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 claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution."[50] Frequently, the surety will have a contingent, unliquidated claim for a portion of its loss in the debtor's bankruptcy case. In the event that an objection is filed to the surety's proof of claim, and the claim remains in part contingent, the surety's contingent claim for reimbursement may be disallowed unless the surety makes one or more payments that liquidates all or a portion of its contingent claim, at which time that portion of the surety's claim may be allowed.[51]

PRACTICE POINTER: The surety should file a contingent claim for the amount of its exposure under the remaining contract and/or commercial surety bonds. The contingent claim should be equal to the sum of the full bond penalties of all of the bonds less any payments made that are part of the surety's liquidated claim.

6. The Surety's Executory Contract Claims.

Subject to bankruptcy court approval, a debtor may assume, assume and assign, or reject any executory contract.[52] Some debtors, either by motion or pursuant to their plan of reorganization, attempt to assume, assume and assign, or reject as executory contracts the surety's contract and/or commercial surety bonds and/or the underlying contracts for which the contract and/or commercial surety bonds were underwritten. While this paper is not the place to debate whether or not a contract or commercial surety bond is an executory contract, the surety may have different claims against the debtor depending on whether the contract and/or commercial surety bonds are assumed (or assumed and assigned) or rejected.

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[49] The surety's contingent 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).

[50] 11 U.S.C. § 502(e)(1)(B). *In re Microwave Products of America, Inc.*, 118 B.R. 566, 574 (Bankr. W.D. Tenn. 1990); *In re Banner Iron Works*, 69 B.R. 548 (Bankr. E.D. Mo. 1987) (court disallowed surety's claim as contingent, *see* Appendix to opinion).

[51] *In re Banner Iron Works*, 69 B.R. 548, 550 (Bankr. E.D. Mo. 1987). Notwithstanding any disallowance of the surety's claim under 11 U.S.C. § 502(e), the surety's liens against the debtor's real and personal property are not void and remain in effect. 11 U.S.C. § 506(d)(1). *In re Microwave Products of America, Inc.*, 118 B.R. 566 (Bankr. W.D. Tenn. 1990) (surety's contingent claim is disallowed, but surety retains its lien); 1 COLLIER ON BANKRUPTCY § 502.06[5], at 502-64 (Lawrence P. King ed., 15th ed. 1996) ('[A] secured claim disallowed under section 502(e) does not affect the validity of the lien related to the claim."). Furthermore, *In re Agway, Inc.*, 2008 WL 2827439 (Bankr. N.D.N.Y. July 18, 2008), the court disallowed the contingent portion of the surety's claim without prejudice to the surety's right to move for reconsideration of the disallowance when the surety made further payments under the bonds in the future. The court ruled that the Bankruptcy Code required disallowance of the contingent claim, but that the surety's ability to move for reconsideration under the Bankruptcy Code and the Bankruptcy Rules amounted to the same thing as a stay of the disallowance of the surety's contingent claim. *See also* section VII.

[52] 11 U.S.C. § 365.

If the debtor assumes one or more contract and/or commercial surety bonds as executory contracts, and there has been a default by the pre-petition principal or the post-petition debtor under the contract and/or commercial surety bonds, the contract and/or commercial surety bonds may not be assumed by the debtor unless the debtor cures or provides adequate assurance that it will promptly cure the default (namely, reimburse the surety for any losses incurred by the surety under the contract and/or commercial surety bonds), compensates the surety for any actual loss it may have arising from the default, and provides adequate assurance of future performance (making sure that there are no future defaults under the contract and/or commercial surety bonds).[53] Therefore, if the debtor seeks to assume one or more contract and/or commercial surety bonds for which the surety has paid losses and incurred expenses, the surety may obtain reimbursement for those losses and expenses as an immediate post-petition administrative expense payment (and <u>not</u> a pre-petition general unsecured claim) if the debtor wishes to assume the contract and/or commercial surety bonds and have them remain in full force and effect. Furthermore, the surety may be able to obtain "adequate assurance of future performance"[54] for the contract and/or commercial surety bonds in the form of collateral security to protect the surety in the event of a future loss payment.

The debtor may determine that it is the estate's best interest that the contract and/or commercial surety bonds be rejected, either by motion or pursuant to the plan of reorganization. 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."[55] The bankruptcy court will set a time within which the surety's claim arising from the rejection of one or more contract and/or commercial surety bonds as executory contracts must be filed.[56]

Realistically, the surety's damages for the rejection of a contract and/or commercial surety bond most likely will be as a result of a claim made against the contract and/or commercial surety bond either before or after the obligee receives notice that the contract and/or commercial surety bond has been rejected. While the proof of claim Bar Date may have passed with respect to the surety's original proof of claim, the surety may have an extended period of time pursuant to the bankruptcy court order for filing claims arising from the rejection of an executory contract to resubmit its claim that may have previously been disallowed due to the contingent and unliquidated nature of that claim. If the surety's claim has now become noncontingent and liquidated upon the rejection of the contract and/or commercial surety bond as an executory contract because the surety has been required to pay a loss, the surety's claim should now become an allowed claim for the amount of the paid loss.

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[53] 11 U.S.C. § 365(b)(1).

[54] 11 U.S.C. § 365(b)(1)(C)

[55] 11 U.S.C. § 502(g). *See also* 11 U.S.C. § 501(d).

[56] Bankruptcy Rule 3002(c)(4).

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

While a discussion of any avoidance action (preferential transfers under section 547 and/or fraudulent transfers under section 548 of the Bankruptcy Code) taken by the trustee or the debtor against the surety are well beyond the scope of this paper, it is possible that the surety may obtain collateral and/or property of the principal that results in the surety receiving a preferential or fraudulent transfer due to the principal's filing of its bankruptcy petition. As stated previously, to the extent that the surety may be liable to the debtor's estate as a result of a preferential or fraudulent transfer, the court may disallow the surety's proof of claim pursuant to 11 U.S.C. § 502(d) "unless such entity or transferee has paid the amount, or paid over any such property, for which such entity or transferee is liable" for such avoidable transfer under the Bankruptcy Code.

Assuming that the surety included the value of the property alleged as a preferential or fraudulent transfer as part of its secured claim, thereby reducing its unsecured claim, upon a return of the debtor's property to the debtor's estate, the amount of the surety's secured claim goes down and the amount of the surety's unsecured claim goes up. The surety is entitled to increase its unsecured proof of claim to the extent that the surety must return the property subject to the avoidance action to the debtor's estate. 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."[57]

IV. <u>THE FIDELITY INSURER'S PROOF OF CLAIM</u>

When a fidelity principal causes a loss to his insured employer, and the fidelity insurer incurs a loss by paying the insured's claim, the fidelity insurer has a claim against the fidelity principal under a number of theories.[58] These theories remain valid when the fidelity principal files a bankruptcy case and becomes a debtor, whether it is a chapter 7, chapter 11 or chapter 13. While most fidelity insurers may seek to hold the fidelity principal, now the debtor, nondischargeable from its debts to the fidelity insurer pursuant to section 523 of the Bankruptcy Code,[59] the fidelity insurer may file a proof of claim in the debtor's bankruptcy case in order to obtain a distribution of the debtor's property.

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[57] *See also* 11 U.S.C. § 501(d).

[58] A fidelity insurer may have a right against its fidelity principal and others as a result of its payment of an insured's claim. Among the more recent publications that discuss salvage and reimbursement by a fidelity insurer, the following are examples: (1) Karen K. Fitzgerald, *Salvage and Recovery, in* COMMERCIAL CRIME POLICY, 2D ED. 535 (Randall I. Marmor & John J. Tomaine eds., 2005) (hereafter "Fitzgerald"); (2) Michael R. Davisson and Susan Koehler Sullivan, *Subrogation and Mitigation, in* HANDLING FIDELITY BOND CLAIMS, 2D ED. 611 (Michael Keeley & Sean Duffy eds., 2005) (hereinafter "Davisson and Sullivan"); (3) Robert J. Berens and Tracey L. Haley, *Bankruptcy: From the Insurer's Point of View, in* HANDLING FIDELITY BOND CLAIMS, 2D ED. 661 (Michael Keeley & Sean Duffy eds., 2005) (hereinafter "Berens and Haley"); and (4) James A. Knox, Jr., *Salvage, in* FINANCIAL INSTITUTION BONDS, 2D ED. 501 (Duncan L. Clore ed., 1998) (hereafter "Knox").

[59] *See* Karen L. Gilman and Bruce L. Corriveau, *The Fight Over Discharge and Dischargeability - Why it Matters* (unpublished paper submitted at the Nineteenth Annual Northeast Surety and Fidelity Claims Conference

In discussing the fidelity insurer's rights of recovery and proof of claim against the fidelity principal, we will examine the fidelity insurer's rights under the two most prevalent standard form fidelity bonds, the Financial Institution Bond (Standard Form No. 24, Revised to April 1, 2004)[60] and the Commercial Crime Policy (Standard Form No. SP 0001, Edition of March, 2000).[61] While there are certainly other forms of fidelity bonds, the concepts behind the fidelity insurer's rights to file a proof of claim when the fidelity principal files its bankruptcy case and becomes a debtor remain the same.

Unlike the contract surety or commercial surety, the fidelity insurer does not have an indemnity agreement or any other written agreement with the fidelity principal under which it may make a claim against the fidelity principal. Rather, the fidelity insurer's rights stem from its contract with the insured, whether it is a Financial Institution Bond or a Commercial Crime Policy. The fidelity insurer may also have common-law rights against the fidelity principal as the wrongdoer.

1. The Fidelity Insurer's Common-Law Reimbursement Claim from the Fidelity Principal

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on September 18, 2008); Gary M. Case, *Pursuing Non-Discharge Actions Against Debtors in Fidelity and Miscellaneous Bond Losses - Risks and Rewards* (unpublished paper submitted at the Seventeenth Annual Northeast Surety and Fidelity Claims Conference on September 21, 2006). *See also* Fitzgerald at pp. 564-65; Davisson and Sullivan at pp. 625-26; and Berens and Haley at pp. 669-72.

[60] Section 7 of the Financial Institution Bond provides as follows:

ASSIGNMENT – SUBROGATION – RECOVERY

Section 7

(a) In the event of payment under this bond, the Insured shall deliver if so requested by the Underwriter, an assignment of such of the Insured's rights, title and interest and causes of action as it has against any person or entity to the extent of the loss payment.

(b) In the event of payment under this bond, the Underwriter shall be subrogated to all of the Insured's rights of recovery therefor against any person or entity to the extent of such payment.

(c) Recoveries, whether effected by the Underwriter or by the Insured, shall be applied, net of the expense of such recovery, first to the satisfaction of the Insured's loss which would otherwise have been paid but for the fact that it is in excess of either the Single or Aggregate Limit of Liability, secondly, to the Underwriter as reimbursement of amounts paid in settlement of the Insured's claim, and thirdly, to the Insured in satisfaction of any Deductible Amount. Recovery on account of loss of securities as set forth in the third paragraph of Section 6 or recovery from reinsurance and/or indemnity of the Underwriter shall not be deemed a recovery as used herein.

(d) The Insured shall execute all papers and render assistance to secure to the Underwriter the rights and causes of action provided for herein. The Insured shall do nothing after discovery of loss to prejudice such rights or causes of action.

[61] Section 22 of the Commercial Crime Policy provides as follows:

22. Transfer of Your Rights to Recovery against Others to Us.

You must transfer to us all your rights of recovery against any person or organization for any loss you sustained and for which we have paid or settled. You also must do everything necessary to secure those rights and do nothing after loss to impair them.

The fidelity insurer may have a common-law reimbursement claim from the fidelity principal that it may assert in the debtor's bankruptcy case.[62]

2. The Fidelity Insurer's Subrogation Claim

When a fidelity insurer pays a claim under a financial institution bond or commercial crime policy, it becomes "subrogated to the insured's right of action against the dishonest employee or anyone else who caused the loss, particularly those who facilitated or participated in the dishonesty or fraud or who benefited from it."[63] Even though subrogation is an equitable right, the financial institution bond provides the fidelity insurer with a contractual subrogation right to the rights of the insured.[64] A number of books discuss the fidelity insurer's subrogation claim in detail.[65]

3. The Fidelity Insurer's Assignment Claim

In addition to the surety's subrogation claim, the surety may also have a contractual assignment of the insured's claim against the fidelity principal, now the debtor, and other third parties.[66] The financial institution bond provides that the fidelity insurer may request an assignment of the insured's rights and that the insured shall execute any documents necessary to assist the fidelity insurer to enforce its rights under the assignment.[67] Pursuant to the commercial crime policy, the insured is required to transfer all of its rights of recovery against any person to the fidelity insurer and do everything necessary to secure those rights for the fidelity insurer.[68]

4. The Fidelity Insurer's Receipt of a Transfer of the Insured's Claim

At the time the fidelity principal files its bankruptcy case and becomes a debtor, the fidelity insurer may not have paid the insured's claim even though the insured may have sustained a covered loss. The insured may file a proof of claim for its loss on its own behalf in

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62 *See* the discussion of the fidelity insurer's indemnity and reimbursement rights in Knox at pp. 510-11. As Knox states, "The Restatement of Suretyship and Guaranty declares that even if a particular fidelity bond does not expressly create a contract of suretyship, it can, as between the insurer, insured and dishonest employee, give rise to suretyship status, including a right of indemnity against the employee." RESTATEMENT (THIRD) SURETYSHIP AND GUARANTY § 1 (1996), particularly § 1(3)(a) and (b) and Comment q. For an in-depth analysis, *see* Hugh E. Reynolds, Jr. and James Dimos, *Fidelity Bonds and the Restatement*, 34 WILLIAM AND MARY LAW REV. 1249 (1993). However, there are cases that state that a fidelity insurer's right of indemnity from a dishonest employee does not exist. *See* Fitzgerald at p. 539 and cases cited in her notes 12 and 13.

63 Knox at p. 502 and his note 3.

64 *See* note 60, *supra.*; *see also* Fitzgerald at pp. 536-38 for a description of the distinctions between the two types of subrogation - "conventional subrogation" (arising from an agreement, either express or implied) and "legal subrogation" (arising by virtue of law and/or equity).

65 *See* Fitzgerald at pp. 536-47, Davisson and Sullivan at pp. 612-14 and 617-20; and Knox at pp. 502-07.

66 *See* Fitzgerald at pp. 536-39; and Knox at pp. 507-9.

67 *See* note 60, supra.

68 *See* note 61, supra.

the debtor's bankruptcy case. When the fidelity insurer ultimately pays the covered claim, the fidelity insurer is entitled to an assignment and transfer of the insured's filed proof of claim and receive any distributions from the debtor's bankruptcy case[69] (consistent with the sharing of recovery provisions, if any, in the applicable fidelity bond).

V. THE SURETY'S REIMBURSEMENT CLAIM UNDER SECTION 502 OF THE BANKRUPTCY CODE AND THE SURETY'S SUBROGATION CLAIM UNDER SECTION 509 OF THE BANKRUPTCY CODE[70]

A surety that pays a claim under a bond has two types of claims: "(1) a claim for reimbursement or contribution, and (2) a subrogation claim; and it is clear under the Code that it cannot have an allowed claim in both categories because that would permit it to effectuate a double recovery."[71] Generally, the Bankruptcy Code preserves for the surety either a right of reimbursement or a right to be subrogated to the claim of the entity that the surety has paid.[72] However, the surety is not entitled to two recoveries, and it must decide upon which of the two rights (reimbursement under the indemnity agreement or pursuant to its subrogation rights) the surety wants to rely.

The interplay between sections 502 and 509 of the Bankruptcy Code address the two types of the surety's claims, one for reimbursement under the indemnity agreement and the other for reimbursement pursuant to the surety's subrogation rights.[73] In summary, the surety may enforce its rights to reimbursement under section 502 or enforce its subrogation rights under section 509, but may not enforce both rights.[74]

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[69] *See* section IX of this paper concerning transfers of claims from one creditor to another.

[70] For a detailed analysis of the treatment of the surety's subrogation rights under the Bankruptcy Code and the various elements that the surety must prove to assert its subrogation rights, *see* Robert F. Carney, *Reimbursement and Subrogation Rights Under the Bankruptcy Code and the Surety's Proof of Claim* (unpublished paper submitted at the Seventh Annual Northeast Surety and Fidelity Claims Conference on October 24, 1996).

[71] *In re Richardson*, 193 B.R. 378, 380 (D.D.C. 1995), *aff'd,* No. 96-7012 (D.C. Cir. filed February 6, 1997), *cert. denied,*

[72] The surety's subrogation rights are preserved under the Bankruptcy Code. Pursuant to 11 U.S.C. § 509(a), "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." If the creditor has not filed its own proof of claim, the surety, as "an entity that is liable to such creditor with the debtor, or that has secured such creditor, may file a proof of such claim." 11 U.S.C. § 501(b). *See also* Bankruptcy Rule 3005(a).

[73] Joanne S. Brooks and Robert F. Carney, The *Impact of the Bankruptcy Code on the Surety's Pursuit of Salvage, in* SALVAGE BY THE SURETY (George J. Bachrach ed., 1998); Robert F. Carney, *Reimbursement and Subrogation Rights Under the Bankruptcy Code and the Surety's Proof of Claim* (unpublished paper submitted at the Seventh Annual Northeast Surety and Fidelity Claims Conference on October 24, 1996).

[74] *See* 11 U.S.C. § 502(e)(1)(C) and 11 U.S.C. § 509(b). While the surety may enforce either its reimbursement rights under the indemnity agreement or its subrogation rights with respect to the claims of others, the surety's subrogation rights may provide the surety with grounds for objecting to the dischargeability of a debt that the surety has paid.

PRACTICE POINTER: The surety should carefully preserve and not waive its subrogation rights in its proof of claim to the extent that the surety may prefer to proceed under its subrogation rights, including with respect to other claims against the debtor, rather than just its reimbursement rights under the indemnity agreement.

Notwithstanding the surety's rights of reimbursement and/or subrogation, the surety's claim may not be entitled obtain a distribution on its allowed claim until the creditor or creditors who are the beneficiaries of the contract and/or commercial surety 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 to the claim of a creditor and for the benefit of such creditor an allowed claim, by way of subrogation under this section, or for reimbursement or contribution, of an entity that is liable with the debtor on, or that has secured, such creditor's claim, until such creditor's claim is paid in full, either through payments under this title or otherwise.

For example, in the event that the obligee claimant of a commercial surety bond has a claim against the principal, now the debtor, in the sum of $150,000, but the penal sum of the commercial surety bond is only $100,000, even if the surety pays the obligee claimant the penal sum of the commercial surety bond of $100,000, the obligee claimant will still be unpaid the sum of $50,000 by the principal debtor. Under section 509(c), if the obligee claimant files a proof of claim for the unpaid $50,000 and the surety files a proof of claim for reimbursement in the sum of $100,000, the surety's allowed claim in the sum of $100,000 shall be subordinated to the $50,000 claim of the obligee claimant, and the surety will not receive a distribution from the debtor's estate until the obligee claimant is paid in full.

VI. THE DOCUMENTATION FOR THE SURETY'S PROOF OF CLAIM.

The surety's proof of claim should be filed on the official form provided by the bankruptcy court.[75] However, the surety should attach to its proof of claim form a narrative describing the basis for the surety's claim, the types of claims that the surety is asserting (secured, unsecured and/or priority), and the amount of the surety's claim. The surety does not have to attach to its proof of claim either copies of all of the bonds or copies of all of the checks or other evidence of payment under the bonds. The surety may attach a list of the bonds and/or a list of all of the payments made under the bonds to the proof of claim, but this is not necessary. The surety should attach a copy of the indemnity agreement[76] (making sure that it blocks out or covers up information that may be contained in a short-form bond application/indemnity agreement or any other indemnity agreement that may have such information as social security numbers, drivers' license numbers, bank account information,

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[75] While the Bankruptcy Rules contain Official Form 10, the form proof of claim, Official Form 10 changes on a fairly regular basis. The most recent form, Form B10 (Official Form 10) (12/07), contained in the most recent Bankruptcy Rules may change in the next year. Furthermore, local bankruptcy courts may have other forms, and there may be an Official Proof of Claim Form in some large chapter 11 bankruptcy cases. While the Bankruptcy Rules provide that a proof of claim must be in writing setting forth a creditor's claim, the proof of claim itself "shall conform substantially to the appropriate Official Form." Bankruptcy Rule 3001(a).

[76] Bankruptcy Rule 3001(c).

etc.), and must provide written evidence of any liens or security interests if the surety has a secured claim against property of the debtor's estate.[77]

The fidelity insurer's proof of claim should also be filed on the Official Form provided by the bankruptcy court, and the fidelity insurer should attach to its proof of claim form a narrative describing the basis for the fidelity insurer's claim, the types of claims that the fidelity insurer is asserting, and the amount of the fidelity insurer's claim. The fidelity insurer should also attach a copy of the relevant fidelity bond, copies of all checks or other evidence of payment under the fidelity bond, and any written assignment of claims that may be provided to or required by the fidelity insurer from the insured.

VII. THE ALLOWANCE OF AND/OR DISALLOWANCE (AND RECONSIDERATION) OF THE SURETY'S PROOF OF CLAIM.

As stated previously, 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.[78] However, a party in interest may object to the surety's proof of claim.[79] The surety's claim under its indemnity agreement is for reimbursement. Section 502(e)(1) of the Bankruptcy Code provides:

> Notwithstanding subsections (a), (b), and (c) of this section and paragraph (2) of this subsection, 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 -
>
> (A) such creditor's claim against the estate is disallowed;[80]
>
> (B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution;[81] or
>
> (C) such entity asserts a right of subrogation to the rights of such creditor under section 509 of this title.[82]

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[77] Bankruptcy Rule 3001(d).

[78] Bankruptcy Rule 3001(f).

[79] 11 U.S.C. § 502(a); Bankruptcy Rule 3007.

[80] In certain circumstances, a creditor's claim against the debtor's estate may be disallowed under some provision of the Bankruptcy Code, yet the surety's bond may be obligated to pay that portion of the creditor's claim. For example, the surety may be obligated to pay the creditor $150,000 under the bond, but, of the $150,000 claim, the creditor's claim for $20,000 of the $150,000 may be disallowed for some reason (attorneys' fees, interest or any other reason that would substantiate the debtor's objection to the creditor's claim). Therefore, even though the surety would otherwise have a reimbursement claim under the indemnity agreement for the full amount of its bond payment of $150,000, section 502(e)(1)(A) may disallow the surety's claim against the debtor's estate to the extent of the $20,000 of the creditor's claim that has been disallowed.

[81] *See* the prior discussion concerning the surety's contingent claims in section III.5.

The bankruptcy court must disallow the surety's claim for reimbursement to the extent provided in section 502(e)(1) of the Bankruptcy Code.

If the surety's proof of claim is a liquidated claim as a result of payments made under the bonds and costs and expenses incurred under the indemnity agreement, several provisions in the indemnity agreement will assist the surety in its attempt to have its claim allowed if an objection to the surety's claim is filed.[83] Those provisions include:

1. The debtor's obligation to indemnify and reimburse the surety under the terms of the indemnity agreement;

2. The surety's entitlement to reimbursement for any and all payments made by the surety in good faith, including under the belief that the surety is or was liable for the sums and amounts paid and/or that it was necessary or expedient for the surety to make such payments; and

3. The prima facie evidence of the fact and the amount of the debtor's liability to the surety documented by vouchers, statement of payments, or other evidence of the surety's payment.

Assuming that the surety's proof of claim under the indemnity agreement is not disallowed under section 502(e)(1) of the Bankruptcy Code, the surety may use other provisions in the indemnity agreement to have its proof of claim (secured, unsecured and/or priority claims) allowed in the debtor's bankruptcy case.

Notwithstanding the allowance or disallowance of the surety's proof of claim, both the allowance and disallowance may be reconsidered for cause. Section 502(j) provides:

> A claim that has been allowed or disallowed may be reconsidered for cause. A reconsidered claim may be allowed or disallowed according to the equities of the case. Reconsideration of a claim under this subsection does not affect the validity of any payment or transfer from the estate made to a holder of an allowed claim on account of such allowed claim that is not reconsidered, but if a reconsidered claim is allowed and is of the same class as such holder's claim, such holder may not receive any additional payment or transfer from the estate on account of such holder's allowed claim until the holder of such reconsidered and allowed claim receives payment on account of such claim proportionate in value to that already received by such other holder. This subsection does not alter or modify the trustee's right to recover from a creditor any excess payment or transfer made to such creditor.

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[82] *See* section V. 11 U.S.C. § 509(b)(1) acts as a parallel provision to 11 U.S.C. § 502(e)(1)(C) and prevents the surety from having both a claim for reimbursement under its indemnity agreement and a claim for subrogation to the rights of the creditor that the surety has paid.

[83] *See* THE SURETY'S INDEMNITY AGREEMENT - LAW & PRACTICE, 2D ED. 483-84 (Marilyn Klinger, George J. Bachrach and Tracey L. Haley eds., 2008).

Bankruptcy Rule 3008 also concerns the reconsideration of claims.[84]

VIII. SUBORDINATION OF THE SURETY'S CLAIM.

Section 510 has two major concepts that may be applicable to the surety. Pursuant to section 510(a), "a subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable non-bankruptcy law." Many sureties obtain subordination agreements from their principals, indemnitors and even various lenders and other creditors of the principal and the indemnitors. To the extent that the surety has a valid pre-petition subordination agreement that gives the surety additional rights, that subordination agreement will be enforceable in the debtor's bankruptcy case based upon applicable non-bankruptcy law. In the same vein, if the surety has executed such a subordination agreement in favor of other entities, the surety will be bound to the terms of that subordination agreement to the same extent.

Section 510(c) deals with another issue, namely whether a creditor's claim should be equitably subordinated to the claims of one or more other creditors for whatever reasons that the court may find. Specifically, section 510(c) provides:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may -
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
> (2) order that any lien securing such a subordinated claim be transferred to the estate.

There are many non-surety and non-fidelity insurer cases that deal with the issue of equitable subordination. This is not an issue that most sureties and fidelity insurers need to be concerned about when acting in their customary and normal underwriting and/or claims activities.

IX. TRANSFERS OF CLAIMS.

Once the surety's liquidated claim has been allowed, the surety may want to consider whether the best means to maximize its recovery is through a sale of the surety's claim. The method to effectuate such a sale and the factors to be considered in establishing a purchase price are beyond the scope of this paper but are addressed in other publications.[85]

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[84] Pursuant to Bankruptcy Rule 3008, "A party in interest may move for reconsideration of an order allowing or disallowing a claim against the estate. The court after a hearing on notice shall enter an appropriate order." *See also* note 51, *supra,* and *In re Agway, Inc.*, 2008 WL 2827439 (Bankr. N.D.N.Y. July 18, 2008).

[85] *See* Joanne S. Brooks and Robert F. Carney, *The Impact of the Bankruptcy Code on the Surety's Pursuit of Salvage, in* SALVAGE BY THE SURETY (George J. Bachrach ed., 1998). Bankruptcy Rule 3001(e) concerns transferred claims, including the transfer of a claim other than for security both before and after the proof of claim is filed and the transfer of a claim for security both before and after a proof of claim is filed.

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From 1996 to 1999, he served as an associate attorney working with his father at the law firm of Lanak & Hanna, P.C. in Santa Ana, California. In January 2000, he joined American Contractors Indemnity Company (ACIC) as the Director of Claims, and later that year he also assumed the position of Vice President. In 2002, he was given an additional position of General Counsel.

When HCC Insurance Holdings, Inc. acquired ACIC and formed HCC Surety Group, he was promoted to his present position, Senior Vice President - Claims. He currently manages and is responsible for HCC Surety Group's claims, subrogation and collateral departments. He also is responsible for HCC Credit's domestic and international trade credit insurance claims.