TWELFTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS CONFERENCE

GOT A MULTI-STATE MESS AND A BANKRUPTCY? MAYBE A CHANNELING INJUNCTION WILL WORK

PRESENTED BY:

TOM R. BARBER
COATS, ROSE, YALE, RYMAN & LEE, P.C.
17225 El Camino Real, Suite 240
Houston, Texas 77058

And

STEVEN LEYH
LEYH & PAYNE, L.L.P.
5850 San Felipe, Suite 370
Houston, Texas 77057

INTRODUCTION

Sureties are often confronted with a large principal, working in more than one jurisdiction with projects in various stages of completion and hundreds of claims for unpaid bills. To further complicate matters, there may have been insured losses resulting from one or more occurrences on one or more of their bonded projects. Often, the bonded contractor will be in or at the point of bankruptcy. Wouldn't it be nice if you could "hit the pause button", sort the completion costs and unpaid bills out, force the insurance carriers to come to the table on the insured losses, and determine payment bond coverage for the unpaid bills in a single forum, using a single procedure – maybe even stop any lien claims from being foreclosed in the interim?

The possibility of accomplishing this result exists utilizing the so-called "Channeling Injunction" available under bankruptcy law.

BANKRUPTCY ASPECTS

1. Bankruptcy Court has jurisdiction to enter a channeling injunction

   A. §1334(b) "related to" or "arising in" is the relevant section

   B. §105 of 11 U.S.C.

   C. Article III Court is a U.S. District Court. A bankruptcy court is **not** an Article III court. Sweeping reform of the Bankruptcy Code in 1978 brought about the *Northern Pipeline Co. v. Marathon Pipeline Co.*, 102 S. Ct. 2858 decision. The Bankruptcy Amendments and Federal Judgeship Act of 1984 "refined" the jurisdiction of bankruptcy courts.

   D. Automatic referral of bankruptcy cases from district court to bankruptcy court. 28 U.S.C. 157(a)

   E. Bankruptcy court jurisdiction is very broad.

   F. Bankruptcy court has jurisdiction

   G. Contra argument: lien procedures are *"in rem"* proceedings against property, not of the estate, and therefore, no jurisdiction.

2. The substantive law that allows this procedure is §105 and §362 Bankruptcy Code; Rule 65 of the Federal Rules of Civil Procedure and Bankruptcy Rule 7065 (Injunctions)

   A. §362 of Title 11 U.S.C.

   "(1) the Commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of

the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title."…

Commencing or continuing the prosecution of claims against the builder's risk may interfere with or deplete the property of the estate, in particular, the proceeds of the builder's risk policy. The same argument can be made as to an applicable CGL policy. Additionally, prosecution of claims against the bond may interfere with or deplete the property of the estate. To the extent that the surety is required to pay a claim under the bond, under its contractual indemnity agreement, it can insist that the obligee reimburse the surety out of the contract balances, or use the contract balances to pay the claim. Either results in a lesser amount of contract balances available for estate.

B. §105(a) of Title 11 U.S.C. – authorizes the court to issue "any order, process or judgment that is necessary or appropriate to carry out the provisions of this title". 11 U.S.C. §105(a). Relief under §105 is particularly appropriate in a case when it is necessary to protect and preserve property of the estate.

C. F.R.C.P. Rule 65 – addresses injunctive relief. Bankruptcy Rule 7065 makes Rule 65 applicable in adversary proceedings. The judicial tests for the availability of any injunctive relief apply. They must be carefully addressed. The granting of relief under §105 is governed by the traditional requirements for relief under F.R.C.P. 65 pursuant to Bankruptcy Rule 7065. *Glassman v. Electric Theater Restaurant Corp. (In re: Electronic Theater Restaurant Corp.)*, 54 B.R. 458, 462 (N.D. Ohio 1985); In *In re: Zale Corp.,* 62 F.3d 746, the 5th Circuit articulated the prerequisites for a preliminary injunction:

(1) substantial likelihood that the movant will prevail on the merits;
(2) substantial threat that the movant will suffer irreparable injury if the injunction is not granted;
(3) the threat of injury to the movant outweighs the threat of harm an injunction may cause the party opposing the injunction; and
(4) that granting the injunction will not disserve the public interest.

ADDRESSING EACH ELEMENT

(1) As to the likelihood of success, is important to stress that some amount of money is owed to the debtor by the owner. By then stressing that those funds will not be available to the debtor unless and until all claims have been resolved, it sets the stage for the argument. Additionally, arguing that insurance proceeds may be available to the debtor, and until all claims are resolved, insurance proceeds will not be available to the debtor, encourages the court to make a finding that the insurance policy proceeds are property of the estate.

(2) Irreparable harm to the estate is likely to be addressed by an affidavit from a representative of the debtor-in-possession or an affidavit from the

trustee. *In re: A.H. Robbins, Co.,* 788 F.2d 994 at 1008 contains a good analysis of irreparable injury by depletion of the estate's assets.

(3) Any alleged harm to the defendants can usually be overcome by the argument and proof that claimants retain their appropriate position while the estate, insurer and the bonding company resolve all claims with a swift judicial determination of various contractual agreements.

(4) This procedure serves the public interest by making a swift determination of all claims.

D. Case law - §362 – the argument that this relief is found in §362 of the Bankruptcy Code is proceeded by the argument that the potential proceeds of the insurance policy constitutes property of the estate. *Trangali v. Hathaway Machinery Co., Inc.*, 796 F.2d 553 (First Circuit, 1986). *Trangali* was adopted by the 5th Circuit. *In re: Viatek*, 51 F.3d 530 (Fifth Circuit, 1995). Adopting *Trangali*'s logic, the 5th Circuit wrote

> "the language in 541(a)(1) is unquestioningly broad enough to cover a debtor's interest in liability insurance. Indeed, an overwhelmingly majority of courts have considered that liability insurance policies fall within 541(a)'s definition of an estate's property."

Building upon a prior holding in the case of *S.I. Acquisition, Inc. v. Eastway Delivery Service, Inc.*, 817 F.2d 1142 (Fifth Circuit, 1987), the Fifth Circuit recently set forth the analytical scheme for determining whether the stay pursuant to §362 applies to claims against non-debtors. In the case of *Schimmelpenninck v. Byrne,* 183 F.3d 347, 355 (Fifth Circuit, 1999) the court set out the test. This test is:

(1) the automatic stay applies to cause of action that state or federal law holds belongs to the debtor; or

(2) the automatic stay applies to a cause of action that seeks to recover property to the estate when the property is held or controlled by a person or entity other than the debtor; and

(3) in applying the above rules, you must keep in mind that the general bankruptcy policies for procuring and preserving the debtor's property and insuring equal distribution of the debtor's assets to similarly situated creditors.

Therefore, the courts have held the channeling injunction has its basis in §362 of Title 11.

E. Case Law §105 – the case of *Celotex v. Edwards*, 514 U.S. 300, (1995) indicates the Court has the authority to enter a temporary restraining order

pursuant to its powers under §105. The requisites of a temporary restraining order were discussed *supra*. §105 of the Bankruptcy Code authorizes the court to:

> "issue any order, process or judgment necessary to carry out the provisions of [Title 11]."

The Fifth Circuit has held stay of actions against non-debtors may be entered via §105 injunction under "unusual circumstances". *In re: Zale Corp.,* 62 F.3d 746, 761 (Fifth Circuit, 1995). Such circumstances are that the non-debtor and the debtor enjoy such identity of interest that the suit against the non-debtor is essentially a suit against the debtor. The *Zale* circumstances are present with respect to continued prosecutions of claimants' lawsuits against a builder's risk carrier and owner and/or bonding company. The liability of a builder's risk carrier or owner and/or bonding company may arise based on claims that are derivative of a principal's liability, if any. To the extent that these actions are really directed against the Trustee or the debtor-of-possession, they thus fulfill the *Zale* circumstance. Additionally, the Trustee or Debtor-in-possession will be distracted if he is forced to deal with a number of lawsuits in different forums defending against the potential preclusion and evidiciary prejudice against him and the estate, and the threat to the proceeds of any builder's risk policy which would ultimately harm the estate.

3. **PLEADINGS**: Attached is a form Complaint, Application for Temporary Restraining Order, Preliminary Injunction and Temporary Restraining Order. Notice it was brought as an adversary proceeding; you must. Therefore, you have to obtain a summons for every Defendant and serve them. The bankruptcy rules allow service by mail, but it is critical that you be able to demonstrate service. As you are quite likely going to seek injunctive relief on an expedited basis, you want the summons and complaint served promptly. Additionally, please recall that you are going to have to prove that, in fact, the summons and complaint were received. In this case, we served the defendants by priority, overnight mail, certified, return receipt requested. Though cumbersome and expensive, it was invaluable in persuading the bankruptcy judge to grant the relief requested.

   After you obtain a temporary restraining order it is going to have to be served in the same fashion. Once again, you must be able to prove service and receipt of the Order. If a separate notice is issued for preliminary injunction hearing, it will have to be served. Lastly, when the preliminary injunction obtained, it will have to be served in a like manner. Clearly, if you seek to enforce these orders by contempt, which you might, you must be able to prove service.

4. **KEY PITCH** - To persuade a competent bankruptcy judge to grant the relief that a surety would seek by a channeling injunction, you have to take a step back from the role of advocate for the surety. You must convince the bankruptcy judge that there is a substantial likelihood of a benefit to the **estate** (not your client). Whether it is a Chapter 7 and a benefit to the unsecured creditors, or a Chapter 11 and a benefit to a

debtor attempting to reorganization, you must convince the bankruptcy judge that there **IS** a benefit. Therefore, you must convince the bankruptcy judge that either the proceeds of the builders risk policy or the proceeds in the CGL policy or some other asset is going to come into the estate. You need to downplay the benefit to the surety. It will not be persuasive to a bankruptcy judge to enter a channeling injunction to benefit a surety company and possibly save it money. That argument can be made indirectly by claiming that the surety's claim against the debtor will be reduced by this procedure, but I would not advance that as my key argument. The key argument is to hold hands with the debtor or the trustee and argue that a channeling injunction is absolutely a benefit of the estate, with little or no harm to the defendants.

5. **BONDING FOR THE INJUNCTION** – if you make the trustee a plaintiff in the case, you can seek this injunctive relief without having to post a bond. If you go with the debtor-in-position, or go it alone, someone is going to have to put up a bond.

SURETY ASPECTS

To be considered for use by the surety, one or more factors need to represent a significant problem for the surety.

1. Multiple claims with, potentially, similar coverage issues.

2. Multiple locations where claims are asserted – this can either be multiple counties within the same state or multiple state jurisdictions.

3. Potentially large sources of subrogation recoveries, such as insurance assets. For instance, there may be completed operations coverages available to correct defective work installed by subcontractors, which work, in turn, is the subject of the Obligee's complaints and allegations under the performance bond. Alternatively, there may be unpaid labor and material claims that are more properly the subject of builders risk coverage.

4. The surety's greatest exposure is under its payment bonds and it is (rightfully) concerned that such losses, if paid, will be reimbursed (or paid first) out of contract balances.

5. The proper amount of contract balances payable, together with amounts expended by the Obligee towards completion are in question.

6. The surety is being sued unconscious in a lot of different places and it, as well as its attorneys, don't know what to do.

ADVANTAGES AND DISADVANTAGES

The surety has decided that enough factors are present that it should consider the Channeling Injunction option, but, before making a decision, wants to know the "pros and cons". The principal advantages and disadvantages are tabulated below.

	PRO
1	All claims in one forum.
2	Possibly more astute judge than in state court.
3	Deduction of costs by being in one forum.
4	No inconsistent results.
5	No res judicata or collateral estoppel.
6	No issue preclusion.
7	Common discovery.
8	Expeditious resolution of all claims and issues.
9	Prevents prosecution of claims against bond, which may deplete assets of estate.
10	Precludes filing of 80 §362 motions to include debtor in state court litigation to liquidate claim.
11	Prevents prosecution of claims against insurance, which may deplete assets of estate.
12	Enjoins pending litigation.
13	Enjoins filing of new litigation.
14	Bankruptcy court is usually "rocket docket" without special consideration.
15	Bankruptcy court orders insurance company and bonding company not to pay claims - heads off delay and bad faith claims.
16	Prevents violation of §362 stay and litigation thereon.
17	Provides a forum where insurance proceeds are likely to be found property of the estate.

	PRO
18	Prevents irreparable harm to estate.
19	Is in public interest.

	CON
1	Expensive for surety to initiate.
2	Bankruptcy Judge may decline to do it based on: A)Jurisdictional, “not related to” or “arising under” B)Elect to abstain C) *in rem* proceedings, not debtor’s property
3	If judge declines to do it, Surety has awakened all creditors
4	May alert debtor to claim to contract balances.
5	If “untoward” ruling on a discrete issue, stuck with it for all claims.
6	Surety submits to jurisdiction of Bankruptcy Court.
7	Can be argued to have been done for no reason other than to harm smaller, out of area creditors.

CONCLUSION

As with the administration of all complex cases, the attempted employment of the Channeling Injunction device should be carefully considered. There are substantial risks and expenses associated with this option. However, in many instances, such risks will be present with other available options and the potential for expense may be much greater. Typical of alternatives involving great risks, the rewards can also be great. However, if the surety seeks to employ this tactic, it needs to make the decision early and, thereafter, take the lead in controlling the legal work to the maximum extent possible.