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**WHEN THE PRINCIPAL GIVES YOU LEMONS, MAKE
LEMONADE: TURNING THE PRINCIPALS BANKRUPTCY TO
THE SURETY'S ADVANTAGE**

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So your principal has filed for bankruptcy. It may not be a bad thing. Take that lemon, add some sugar and ice, and make a nice cool pitcher of lemonade. This paper focuses on a surety's options in the principal's Chapter 11 proceeding. The recipe for success is as follows:

1. Add Involvement.

The most important step a surety can take not only protect itself but also to make use of the principal's bankruptcy, is to get active early. Let the court know that the surety is an important player and that you will have to be dealt with.

2. Carefully Blend in the Contract Funds.

In keeping with step one, a surety should promptly file its "first day motions" to protect the contract funds. These protective motions include: (1) a motion to set a time certain for the debtor to accept or reject the contract pursuant to 11 U.S.C. § 365(d)(2); (2) a motion for adequate protection pursuant to 11 U.S.C. § 363(e); and (3) a motion to lift the stay pursuant to 11 U.S.C. § 362(d) to allow the surety to assume control over the contract funds.

A. The Surety's Interest in Contract Funds.

The principle that the surety has a priority right to unpaid contract funds which have not been earned by the principal generally holds true in bankruptcy court. In fact, many courts have held that where the debtor fails to pay his subcontractors and suppliers, the debtor fails to earn contract balances attributable to the subcontractor and supplier, and the contract balances are not property of the estate.¹ However, some courts have treated the funds as estate property.² Therefore, the surety should move to lift the stay before attempting to take any action with regard to contract funds.

¹ See In re Modular Structures, Inc., 27 F.3d 72, 77 (3^d Cir. 1994); Trinity Universal Ins. Co. v. United States, 382 F.2d 317, 320 (5th Cir. 1967), cert. denied, 390 U.S. 906, 88 S.Ct. 820 (1968); In re Pacific Marine Dredging & Construction, 79 B.R. 924, 929 (Bankr. D.Or. 1987).

² See In re Alliance Properties, Inc., 104 B.R. 306 (S.D. Cal. 1989) (holding that surety held an equitable interest in contract proceeds and that to extent surety discharged debt to subcontractors, the contract proceeds were property of the estate subject to an equitable lien of the surety).

Questions regarding a surety's equitable subrogation right sometimes arise when the surety has not completed the project. In a recent bankruptcy case, the court recognized the equitable subrogation rights of a surety issuing lien release bonds. See In re Colt Engineering, Inc., 288 B.R. 861, 872-73 (Bankr. C.D. Ca. 2003) (finding that when a surety issues lien release bonds the surety is still entitled to priority payment of the remaining contract funds under the theory of equitable subrogation).

A surety may also be able to cross-collateralize contract funds from one project to another. In USF&G v. Housing A. Town of Berwick, 557 F.2d 482 (5th Cir. 1977), the Court held that a surety could cross-collateralize contract funds between projects with the same owner. The Indemnity Agreement may also contain language allowing the surety to use contract funds and contract claims from one bonded project to satisfy losses on another bonded project. Contractual cross collateralization has been upheld in a Louisiana bankruptcy action. See Louisiana Industrial Coatings, Inc. v. Boh Bros. Construction Co., Inc., 53 B.R. 464 (E.D. La. 1985).

B. Pre-Petition Waivers of the Automatic Stay.

While the surety could include in its agreements with the principal a right to termination of the automatic stay upon a declaration of default by an obligee under a bonded contract and waiver of the principal's right to object to a motion to lift the stay, this may not be enforceable. A majority of the courts addressing the issue have found that a debtor cannot waive the automatic stay.³ These courts have noted that the automatic stay is designed to protect both creditors and debtors, and cannot be unilaterally waived by the debtor.⁴ However, some courts have recognized a limited ability by the debtor to waive the protection of the automatic stay for instance, by actively participating in litigation outside the bankruptcy court.⁵

³ See In re Guthrie, 1996 WL 285670 (9th Cir. 1996) (unpublished); Constitution Bank v. Tubbs, 68 F.3d 685 (3^d Cir. 1995); Ostano Commerzanstalt v. Telewide Systems, Inc., 790 F.2d 206 (2^d Cir. 1986); Farm Credit of Central Fla. v. Polk, 160 B.R. 870 (M.D. Fla. 1993); In re Gullett, 230 B.R. 321 (Bankr. S.D. Tex. 1999), *rev'd on other grounds*, 253 B.R. 796 (S.D. Tex. 1999); In re Madison, 184 B.R. 686 (Bankr. E.D. Pa. 1995). See also In re Enron Corp, 300 B.R. 201 (Bankr. S.D.N.Y. 2003); In re Izzi, 295 B.R. 754 (E.D. Pa. 2003); In re Vierkant, 240 B.R. 317 (B.A.P 8th Cir. 1999).

⁴ "Only the bankruptcy court with jurisdiction over a debtor's case has the authority to grant relief from the stay of judicial proceedings against the debtor." Gullett, supra, 230 B.R. at 330 (citations omitted).

⁵ See In re Atrium High Point Ltd. Partnership, 189 B.R. 599 (Bankr. M.D.N.C. 1995) (holding that waiver is enforceable against debtor in appropriate cases, but cannot bind third parties); In re Cobb, 88 B.R. 119 (Bankr. W.D. Tex. 1988) (citing the general rule that waivers are not enforceable but noting that the debtor can waive the protection of the stay by actively participating in litigation outside the bankruptcy); In the Matter of Sumerall, 56 B.R. 134 (Bankr. M.D. Fla. 1985) (noting *in dicta* that the debtor may waive the automatic stay as it relates to his protection, he cannot waive the protection

A few courts have held that pre-petition agreements waiving the automatic stay are binding and enforceable.⁶ The rationale is that a waiver of the stay differs from a provision barring bankruptcy and, therefore, does not violate public policy; and that enforcing certain pre-petition agreements encourages out of court restructuring and settlement. Another approach is to allow a creditor to use the waiver as a basis, but not the sole basis, for a request to lift the stay. In other words, the court has the discretion to enforce the waiver if cause to the lift the stay exists.⁷

C. Adequate Protection.

On the request of an entity holding an interest in cash collateral, the Court "shall prohibit or condition such use . . . as is necessary to provide adequate protection of such interest." 11 U.S.C. § 363(e). The party seeking adequate protection bears the burden of showing the validity, priority and extent of its interest in the contract balances. 11 U.S.C. § 363 (o)(1). The surety can generally carry this burden based on its indemnity agreement, legal and equitable subrogation rights, and any recorded UCC-1 statements. On the other hand, the debtor bears the burden of proving that they have provided adequate protection of the surety's interest in the contract balances. 11 U.S.C. § 363(o)(1).

Courts have protected the surety's interest in contract funds by limiting the debtor's use of the contract funds to the bonded project and requiring the debtor to separately account for contract funds.⁸ In one case, the Court ordered that the debtor use bonded contract funds for the completion of work and payment of claims under the bonded contract, stating that:

. . . the stream of payments cannot be diverted from the jobs to which they relate. We have consistently ruled, on various

afforded by the stay to property of the estate).

⁶ In re Cheeks, 167 B.R. 817 (Bankr. D. S.C. 1994) (the court did note that it would hear any third party objections to a motion to lift stay); In re Club Tower, LP, 138 B.R. 307 (Bankr. N.D. Ga. 1991) (the court also found that the stay could be lifted because the bankruptcy filing was in bad faith); In re Citadel Properties, Inc., 86 B.R. 275 (M.D. Fla. 1988) (same). This decision conflicts with the 1993 Farm Credit decision, *supra*, out of the United States District Court for the Middle District of Florida. While it did not expressly overrule Citadel, the Farm Credit court noted that Citadel involved a single asset bankruptcy and that the Citadel court found that the bankruptcy filing was in bad faith.

⁷ See In re Wheaton Oaks Office Partners, 1992 WL 381047 (Bankr. N.D. Ill. 1992).

⁸ See In re RAM Construction Co., 32 B.R. 758 (Bankr. W.D. Pa. 1983) (noting that "the surety would not be adequately protected if the Debtor was free to pay money received from the owners for Debtor's expenses on other contracts"); In re Glover Construction Co., 30 B.R. 873 (Bankr. W.D. Ky. 1983).

motions, that payments must be first applied to those claims on which the surety is or may become liable before the Chapter 11 debtor can be paid the first discretionary dollar.⁹

See also § 363(c)(4) (requiring the debtor to “segregate and account for any cash collateral”).

3. Stir in Completion Options.

A. Post-Petition Financing.

If the debtor is capable of completing the project with financial assistance and will have assets to satisfy administrative claims, it may be in the surety’s best interest to provide post-petition financing to the debtor. The surety should be able to secure a super-priority administrative claim for home office financing, and a recognition of its priority right to contract funds for its bonded work financing. In drafting a financing agreement, the surety should attempt to have as many expenses as possible, including insurance expenses, classified as administrative rather than bonded job costs.

The surety may also be able to assert an administrative claim for financing provided after the bankruptcy filing but before the financing agreement is approved. Although such relief is not routine, courts have repeatedly recognized that the bankruptcy court has authority to grant *nunc pro tunc* approval of advances made after the Petition date.¹⁰ In determining whether to grant *nunc pro tunc* approval of a post-petition loan, courts have applied the following factors:

1. Whether the court is confident that it would have approved the loan had the application for financing been timely made;
2. Whether the court is reasonably persuaded that no creditor has been harmed by continuation of the business made possible by the loan; and

⁹ Glover, supra, 30 B.R. at 880.

¹⁰ See In re Photo Promotion Associates, Inc., 881 F.2d 6 (2nd Cir. 1989); In re American Cooler Company, Inc., 125 F.2d 496 (2^d Cir. 1942); In re Light Coal Mining Company, 122 B.R. 692 (N.D.W.V. 1990).

3. Whether the debtor and lender honestly believe that they have the authority to enter into the loan transaction.¹¹

Section 303(f) of the Code permits "any business of the debtor [to] continue to operate, and the debtor [to] continue to use, acquire, or dispose of property as if an involuntary case concerning the debtor had not been commenced." This section can be argued to satisfy the third requirement for *nunc pro tunc* approval.

B. When the Debtor wants to assume, but the surety wants rejection.

What happens if the debtor wants to assume the contract, but the surety does not want to complete with the debtor? The surety's first line of defense is to oppose assumption of the contract under 11 U.S.C. 365.

If the debtor is permitted to assume the contract, will the surety be obligated under the bond for performance of the assumed contract? The answer may turn on whether the assumed contract is a novation of or differs materially from the original contract. A second issue is whether the bond may be assumed with the contract.

(i) Novation and Material Alteration.

Frequently, contractual terms are modified prior to the assumption of the contract in the bankruptcy to induce both the debtor to assume and the obligee to support assumption. If this is the case, the surety may assert that the modifications are a novation of the original contract or material alterations which void the bond.¹²

A novation is the substitution of a new obligation for an existing one, which thereby discharges the parties from all of their obligations under the former agreement, inasmuch as such obligations are extinguished by the novation. The novation of a contract, the performance of which is guaranteed by sureties who do not consent to the novation, absolves them of their liability, which disappears with the debt it secured.¹³ In

¹¹ See In re Light Coal Mining Company, *supra*.

¹² Note that in many jurisdictions, the release of the surety on the performance bond based on material alterations by the obligee and principal does not release the surety from exposure to payment bond claimants. See 7 Am. Jur. 2d Contractors' Bonds § 121; La. R.S. 9:4812(E); First National Ins. Co. of America v. Lynn, 525 F.2d 1 (1st Cir. 1975); USF&G v. Borden Metal Prod. Co., 539 S.W.2d 170, 175 (Tex. App. 9th Dist. 1976). But see Maryland Cas. Co. v. City of South Norfolk, 54 F.2d 1032, 1039, *reh'g denied and opinion modified on other grounds*, 56 F.2d 822 (4th Cir. 1932); Progressive Clay Co. v. Globe Indemnity Co., 287 N.Y.S. 358 (N.Y. App. Div.) (per curiam), *aff'd*, 272 N.Y. 590 (1936).

¹³ 58 Am. Jur. 2d Novation § 46 (1989). It has been stated that "a surety is discharged by the novation

the context of a contract surety, it has been noted that where changes in the original contract "are so great as to amount to the abandonment of the bonded contract," the surety should be discharged.¹⁴

Generally, a material modification of the underlying contract also releases a surety from its obligations to the obligee, although in many cases the surety must prove prejudice in addition to a material alteration.¹⁵ Substantial extensions of time in performance, changes in the scope of work, and changes in the contract price have been deemed material alterations which release the surety from any obligation to the obligee under the bond.¹⁶

ii. Can the Bond be Assumed?

Additionally, there is bankruptcy case law which classifies surety bonds as financial accommodations which cannot be assumed. 11 U.S.C. § 365(c)(2) provides that an executory contract which extends "financial accommodations, to or for the benefit of the debtor" may not be assumed or assigned by the debtor. § 365(c)(2). Two courts have held that surety bonds are financial accommodations which cannot be assumed by the debtor. See In the Matter of Edwards Mobile Home Sales, Inc., 119 B.R. 857, 859 (Bankr. M.D. Fla. 1990); In re Wegner Farms Co. v. Merchants Bonding Co., 49 B.R. 440, 444 (Bankr. N.D. Iowa 1985).¹⁷

of a debt; for he can no longer be bound for the first debt for which he was surety, since it no longer subsists, having been extinguished by the novation; neither can he be bound for the new debt, into which the first has been converted, since this new debt was not the debt to which he acceded." Williams v. Crusader Discount Corp., 334 P.2d 843, 846 (Nev. 1959) (citation omitted).

¹⁴ See Area Masonry, Ltd. v. Dormitory Authority, 407 N.Y.S.2d 279, 281 (N.Y. App. Div. 1978); see also Winston Corp. v. Continental Casualty Co., 508 F.2d 1298, 1301 (6th Cir.), cert. denied by Continental Cas. Co. v. Winston Corp., 423 U.S. 914 (1975) (Georgia law); United Bonding Ins. Co. v. Southeast Regional Builders, Inc., 236 So. 2d 460 (Fla. App. 1970); Ridenour v. Haynes, No. 1886, 1931 WL 2133 (Ohio App. 1931).

¹⁵ See In re Liquidation of Union Indem. Ins. Co. of New York, 632 N.Y.S.2d 788 (N.Y. App. Div. 1995); Wynnegar v. Southwestern Co., 83 So. 3 (Miss. 1919).

¹⁶ See U.S. ex rel. Army Athletic Association v. Reliance Ins. Co., 799 F.2d 1382, 1386 (9th Cir. 1986); Carriage Town, Inc. v. Landco, Inc., 998 F. Supp. 646, 649 (D.S.C. 1998) Employers Ins. v. Wausau, 377 S.E.2d 119 (S.C. App. 1989); State v. Preferred Accident Ins. Co. of New York, 149 So.2d 632 (La. App. 1st Cir. 1963); Wright v. A.G. McAdams Lumber Co., 234 S.W. 878 (Tex. App. 1921); Southland Life Ins. Co. v. Stewart, 211 S.W. 460 (Tex. Civ. App. 1919).

¹⁷ Note that the Wegner and Edwards courts held that the surety was not permitted to cancel the bond without moving to lift the stay.

Wegner and Edwards involved miscellaneous bonds which provide coverage for a term rather than a specific contract, such as grain dealers and mobile home dealers bonds, which could be canceled by the surety under the terms of the bond. Here the performance and payment bond cannot be canceled; therefore, these cases are distinguishable. However, the Edwards court reasoned that surety bonds are financial accommodations simply because they obligate the surety to pay the principal's obligations if the principal failed to do so. Since the surety is obligated to pay claims under the bond, the bond is a financial accommodation under that definition.¹⁸

While the surety may not be permitted to cancel the bond, if the debtor cannot assume the bond, the obligee would have two options – (1) oppose assumption and make claim under the bond; or (2) enter into a new “unbonded” contract with the principal. If the obligee elects option 2, the surety may assert that its obligations under the bond, which guarantee the original contract, do not extend to the new contract. To hold otherwise would permit a debtor and obligee to unilaterally negotiate terms for assumption highly prejudicial to the surety. Such a holding would expand the contract surety's liability far beyond that assumed under the bond.

There is little case law on the surety bond as financial accommodation issue, and no reported decisions which discuss the contract surety's post-termination duties.

4. Sprinkle a liberal dose of affirmative claims litigation.

The bankruptcy court can be a favorable venue for asserting claims against the owner, design professionals and other third parties. The use of adversary proceedings permits the surety to bring all claims into one forum. Be sure that you have a bankruptcy court that understands the surety's priority right to the proceeds of these claims.

The claims are asserted in the form of adversary proceedings and should join the debtor as a defendant. Under Bankruptcy Rule of Procedure 7001, an adversary proceeding can be filed to recover property and to determine the validity, priority, or extent of a lien or other interest in property.

¹⁸

We located a case note that an unpublished North Dakota bankruptcy court decision found that payment and performance bonds are financial accommodations which are not assumable by the debtor – In re Johnson Constr., Inc., No. 89-05397, slip opinion (Bankr. D.N.D. June 19, 1989). The decision was not on pacer.

The bankruptcy court will have jurisdiction over third party claims if they are "core" bankruptcy matters or are "related to" the bankruptcy.¹⁹ "Core proceedings" are those matters which are solely derived from bankruptcy law, and are set forth in 28 U.S.C. § 157(b). "Related to" jurisdiction is far broader. In this broad grant of jurisdiction, Congress "intended to give federal courts the power to adjudicate all matters having an effect on the bankruptcy."²⁰

The test to be applied in determining whether a proceeding is a "related proceeding" is "whether the outcome of that proceeding could *conceivably* have any effect on the estate being administered in the bankruptcy."²¹ Even when there is a possibility that a suit may ultimately have no effect on a bankruptcy, unless the court can conclude "that it will have no *conceivable* effect," it is a related proceeding. A proceeding is "related to the bankruptcy if the outcome could alter the debtor's rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts upon the handling and administration of the bankrupt estate."²² Under this broad test, clearly a claim for contract funds under a contract of a debtor, which can only be resolved by determining the rights of the debtor to those funds, could *conceivably* have an effect on the estate. Similarly, a claim for reimbursement of contract funds improperly paid under a Contract with the debtor and applicable statutory law, such as an overpayment claim against the owner or design professional, could *conceivably* effect the estate.

The Fifth Circuit has held that "a claim between two non-debtors that will potentially reduce the bankruptcy estate's liabilities produces an effect on the estate sufficient to confer 'related to' jurisdiction."²³ The party asserting jurisdiction is not required to prove this effect to a certainty; jurisdiction attaches on a finding of "any conceivable effect."²⁴ The Supreme Court has similarly acknowledged that suits

¹⁹ Matter of Wood, 825 F.2d 90, 93 (5th Cir. 1987).

²⁰ *Id.*, at 92-93; see also Celotex Corp. v. Edwards, 514 U.S. 300, 308, 115 S.Ct. 1493, 1498-99 (1995) (discussing the breadth of "related to" jurisdiction).

²¹ Wood, *supra*, 825 F.2d at 93 (emphasis in original).

²² Celotex, *supra*, 514 U.S. at 308, n. 6; 115 S.Ct. at 1499, n. 6.

²³ See In re Canion, 196 F.3d 579, 586 (5th Cir. 1999), and cases cited therein.

²⁴ *Id.*, at 587. This "related to" jurisdiction has been found to lapse once the bankruptcy case is closed. The In re Bass case involved the collection of a judgment against the debtor, held nondischargeable, following the close of the bankruptcy case, from a nondebtor. The Court found that the action could not affect the estate because it no longer existed. 171 F.3d 1016, 1022 (5th Cir. 1999).

between third parties that have an effect on the bankruptcy estate fall within "related to" jurisdiction.²⁵

Some courts have recognized that a claim by a creditor against a third party is "related to" the bankruptcy where the creditor would have a claim against the estate if the creditor lost. See, e.g., Celotex, *supra*, 514 U.S. at 309; 115 S.Ct. at 1500 (holding that claim against surety related to the bankruptcy since the surety would then seek to lift the stay to reach collateral posted by the debtor); In re G.S.F., 938 F.2d 1467, 1476 (1st Cir. 1991) (holding that the bankruptcy court had jurisdiction over third-party action because creditor who was defendant in the third-party action would have a substantial contribution claim against the debtor if the creditor lost); In re Wolverine Radio Co., 930 F.2d 1132, 1143 (6th Cir. 1991) (holding that third-party action related to bankruptcy because debtor had agreed pursuant to a reorganization plan to indemnify creditor). Thus, the surety's indemnity claim against the estate provides an additional argument for extending "related to" jurisdiction to third party claims.

5. Hold the Arbitration Clause.

Despite the strong federal policy favoring arbitration, the bankruptcy courts have been granted sound discretion in determining whether to enforce an arbitration provision.²⁶ This discretion "turns on the underlying nature of the proceeding," thus requiring bankruptcy courts to determine whether the proceeding is core or non-core.²⁷ "Core proceedings" are those matters which are solely derived from bankruptcy law, and are set forth in 28 U.S.C. § 157(b).²⁸ "Non-core" proceedings are those controversies that "do not depend upon the bankruptcy laws for their existence- suits that could proceed in another court even in the absence of bankruptcy."²⁹ Thus, the distinction between core and non-core proceedings requires the bankruptcy court to balance the competing provisions and policies of the Federal Arbitration Act and the Bankruptcy Code.³⁰

²⁵ Celotex, *supra*, 514 U.S. at 308, n. 5; 115 S.Ct. at 1499, n. 5.

²⁶ Zimmerman v. Continental Airlines, 712 F.2d 55, 59 (3d Cir. 1983).

²⁷ National Gypsum, *supra*, 118 F.3d at 1067.

²⁸ In re Wood, 825 F.2d 825 F.2d 90, 96 (5th Cir. 1987).

²⁹ *Id.*

³⁰ In re Weinstock, 1999 WL 342764 *8 (Bankr. E.D. Pa. May 25, 1999).

While the bankruptcy court has the discretion to refuse to compel arbitration in a core proceeding, it has been generally accepted that a bankruptcy court has no discretion to refuse to compel arbitration in matters involving non-core proceedings.³¹ The leading case on this issue is Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.³² In Hays, the Court of Appeals reversed the district court's decision denying the enforcement of an arbitration clause in non-core proceedings.³³ The rationale in Hays has been cited with approval in many courts, including the Fifth Circuit opinion National Gypsum, in which the court stated that Hays makes "eminent sense" and is "universally accepted" with respect to debtor-derivative, non-core matters.³⁴ Accordingly, this decision has been interpreted to have "severely limited" the bankruptcy courts' discretion when the proceeding is non-core.³⁵

However, Hays specifically left the door open for bankruptcy courts to exercise its discretion in non-core proceedings if there was a showing that the Bankruptcy Code, in text, legislative history, or purpose, conflicts with the enforcement of an arbitration clause.³⁶ Therefore, when the underlying nature of a proceeding derives exclusively from the Bankruptcy Code and may conflict with the purposes of the Code, the bankruptcy court's discretion to refuse to enforce an arbitration provision is unfettered.³⁷

As seen in National Gypsum, there is no *per se* rule that core proceedings are not arbitrable. Instead, a more protective approach has been applied to ensure that there is little potential for adverse impact on the administration of a bankruptcy case if an arbitration agreement is enforced.³⁸ In the most recent case of Matter of Mintze, the

³¹ See In re Sacred Heart Hospital of Norristown, 181 B.R. 195, 202 (Bankr. E.D. Pa. 1995) (concluding that as to core proceedings, the court "may exercise its full panoply of discretion" in determining whether to enforce an arbitration agreement). *But see* In re Gandy, 299 F.3d 489, 495 (5th Cir. 2002) (finding bankruptcy court have no discretion to refuse to compel arbitration in matters involving non-core proceedings); In re Crysen/Montenay Energy Co., 226 F.3d 160, 165 (2d Cir. 2000) (same); Javitch v. First Union Securities, Inc., 315 F.3d 619, 624 (6th Cir.2003) (same).

³² 885 F.2d 1149 (3d Cir. 1989).

³³ *Id.*, at 1150-51.

³⁴ National Gypsum, *supra*, 118 F.3d at 1066

³⁵ Mintze, *supra*, 2003 WL 22701020 at *3.

³⁶ Hays, 885 F.2d at 1156. *See also*

³⁷ *See* National Gypsum, *supra*, 118 F.3d at 1067.

³⁸ *Id.* at 1067.

district court noted the conflict spawned by Hays and proposed that the only criteria that should be used in determining if the bankruptcy court should exercise its discretion is whether the enforcement of an arbitration agreement would adversely impact the bankruptcy.³⁹

In Mintze, the debtor filed an adversary proceeding to enforce the rescission of a home equity loan pursuant to the Truth in Lending Act. The debtor was referred to the lending company for the financing of a water heater in the amount of \$3,800. However, the debtor alleged that as a condition of financing the heater she was required to borrow \$44,716.34, which included \$2,800 in settlement charges and a \$2,000 life insurance policy. The lender moved to dismiss the adversary proceeding and compel the arbitration provision contained in the loan agreement. The bankruptcy court refused to enforce the arbitration clause because enforcement could adversely affect the outcome of the Chapter 13 plan and its payment distribution. On appeal, the district court concluded that the bankruptcy court acted within the appropriate bounds of its discretion in deciding what was the best forum to resolve the matter.⁴⁰ Similarly, the Second Circuit has held that a bankruptcy court may properly deny enforcement of an arbitration provision if it would have a significant adverse impact on the administration of the bankruptcy case.⁴¹

Thus, the modern trend in both core and non-core proceedings is to determine what effect the arbitration will have on the underlying bankruptcy case.

6. Do not get burned with Chapter 11 Plan.

Be sure to review the Debtor's proposed Plan very carefully. There has been a recent trend for principals to attempt to use the penal sum of the bonds to finance their Chapter 11 plan. For example, in one case, the principal sought forfeiture of the penal sums of the bonds into the bankruptcy proceeding and to be paid the costs of "administering" claims under the bonds from the penal sums. Needless to say, the

³⁹ 2003 WL 22701020 (E.D. Pa. Nov. 12, 2003).

⁴⁰ *Id.*, at *4.

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United States Lines v. Am. S.S. Owners Mut. Prot. & Indem. Ass'n., Inc., 197 F.3d 631, 641 (2d Cir. 1999); *see also In re Pate*, 198 B.R. 841 (Bankr. S.D. Ga. 1996)(the bankruptcy court refused to exercise its discretion in a core proceeding after concluding the debtor failed to establish any adverse effect on the administration of Chapter 13 plan); Matter of RDM Sports Group, Inc. 260 B.R. 905, 914 (Bankr. N.D. Ga. 2001) (the bankruptcy court enforced an arbitration agreement in a non-core proceeding once it determined that enforcement of such agreement would not conflict with the underlying purpose of the Bankruptcy Code).

surety vigorously opposed the plan. Ultimately, the plan was amended to delete this attempt to coerce free financing from the surety.

If faced with a similarly creative debtor, the first line of defense should be that the bankruptcy court lacks jurisdiction to administer the penal sum of the bonds. 28 U.S.C. § 1334(e) grants the District Court “exclusive jurisdiction of all of the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate.” Property of the estate is broadly defined as “all legal or equitable interest of the debtor in property as of the commencement of the estate.” 11 U.S.C. § 541. A principal has no legal or equitable interest in the penal sum of a surety bond; therefore, it is not property of the estate.⁴² As noted by one court, a debtor does not have the right to distribute other people’s property among its creditors. Buna, supra, 503 F.2d at 619.

For the same reason, such a Plan would not meet the confirmation requirement that a plan be proposed in good faith, and not by means forbidden by law since the principal has no right, under the law, to compel payment of the penal sums of a surety bonds. See 11 U.S.C. § 1129(a)(3). Accordingly, the Plan is not proposed in good faith and is proposed by means forbidden by law; and, therefore, is not confirmable.⁴³

Further, a Plan requiring forfeiture of the bond penalty violates the surety’s due process rights and, therefore, is illegal and not confirmable. A corporation is a “person” for purposes of the due process clause of the 14th Amendment.⁴⁴

⁴² See, e.g., In the Matter of Lockard, 884 F.2d 1171, 1178 (9th Cir. 1989); In re Mansfield Tire and Rubber Co., 660 F.2d 1108, 1115 (6th Cir. 1981) (recognizing that a bond posted in favor of a state agency to guarantee payment of workers’ compensation claims was not property of the estate); In re Buna Painting & Drywall Co., Inc., 503 F.2d 618, 619 (9th Cir. 1974) (denying trustee’s request to compel payment of the penal sums of the bond); In re McLean Trucking, 74 B.R. 820, 826-28 (Bankr. W.D. N.C. 1987) (recognizing that a bond posted in favor of a state agency to guarantee payment of workers’ compensation claims was not property of the estate); In re Capitol-York Construction Corp., 43 B.R. 52, 56 (Bankr. S.D. N.Y. 1984); In re Jay Forni, Inc., 33 B.R. 538, 541 (Bankr. N.D. Cal. 1983); See also In re Louisiana World Exposition, Inc., 832 F.2d 1391, 1399-1400 (5th Cir. 1987) (D&O policy is not property of the estate when proceeds are to be paid directly to the officers of the debtor corporation and not to the debtor); Kellog v. Blue Quail Energy, Inc., 831 F.2d 586, 589 (5th Cir. 1987), modified on other grounds, 835 F.2d 584 (1988) (payments made under a secured letter of credit are not property of the estate).

⁴³ § 1129(a)(3); See, e.g., In re Cajun Elec. Corp., 230 B.R. 715 (Bankr. M.D. La. 1999) (plan which attempts to transfer assets which do not belong to the estate fails to comply with § 1129(a)(3)).

⁴⁴ Grosjean v. American Press Co., 297 U.S. 233, 244 (1936); Pierce v. Society of Sisters, 268 U.S. 510, 535, 45 S.Ct. 571 (1925).

Conclusion

Thus, the attentive surety can turn the principal's Chapter 11 filing to its benefit, sit back and enjoy a long, cool drink.