REIMBURSEMENT AND SUBROGATION RIGHTS UNDER THE BANKRUPTCY CODE AND THE SURETY’S PROOF OF CLAIM

By: Robert F. Carney, Esq.

When the principal or indemnitor (generically referred to as the “debtor”) files a petition for relief under the United States Bankruptcy Code (the "Code"), whether it be a chapter 11 reorganization or a chapter 7 liquidation, the debtor’s ultimate goal is to obtain a discharge of all or most of the debts that the debtor owes. The debtor’s bankruptcy does not protect the surety who has issued bonds for or at the request of the debtor. The surety’s goal is to honor its obligations under its bonds while still minimizing its loss. In the bankruptcy context, minimizing that loss may require pursuit of three different objectives. First, the surety will seek reimbursement from the debtor to the extent permitted under the distribution scheme of the Code or the debtor’s plan of reorganization. Second, the surety must protect its subrogation rights, whether in contract funds or rights of recovery against third parties. Third, the surety will maximize its opportunities for reimbursement if it can prevent discharge of the debt owed to it. As disparate as these three objectives sometimes seem, it is in the surety’s proof of claim that all three can either be protected or lost forever.

This paper focuses on how the surety’s three objectives can best be realized in the bankruptcy context, with emphasis on the proof of claim process and the Code’s treatment of subrogation and reimbursement rights. The paper will assiduously ignore state law questions such as the rights to which the surety can be subrogated under applicable state law and the rights of competing claimants to contract funds. In other words, the paper will not discuss what good it is to the surety to actually be subrogated to the rights of a particular creditor or to have reimbursement rights against the debtor.¹

The paper will begin with a rudimentary discussion of claims and proof of claims under the Code and review how the proof of claim form fits into the bankruptcy context and how it should be completed by the surety’s representative. Thereafter, the paper focuses upon subrogation and reimbursement rights under the Code. The paper will discuss subrogation and nondischargeability issues, subrogation rights versus reimbursement rights, and exceptions to the recognition of subrogation and reimbursement rights under the Code.

¹ See, e.g., In re Construction Alternatives, Inc., 2 F.3d 670, 675 (6th Cir. 1993) (even though surety subrogated to rights of the obligee in the debtor’s bankruptcy, subrogation did the surety no good).
I. CLAIMS AND PROOFS OF CLAIM

Simply put, a “claim” is what a creditor (such as the surety) has against the debtor. The debtor’s estate or the “property of the estate” is what the debtor has to share among its creditors. The Code defines a “claim” 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

(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.

This broad definition of a "claim" is consistent with the Code's broad definition of "property of the estate." Section 541 of the Code defines property of the estate to include “all legal or equitable interest of the debtor in property as of the commencement of the case.” These broad definitions are evidence of the Code’s intent to resolve in one bankruptcy proceeding all possible claims against the debtor and to exercise control over all property available to satisfy the claims of the debtor’s creditors.

Not all “claims” are the same. Claims are generally broken down into secured claims and unsecured claims. Other claims are entitled to a priority distribution under the Code. Some claims can be subordinated. The claim is categorized by the Code; it is usually created by applicable non-bankruptcy law. As will be seen, each of these types of claims may be important to the surety.

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A. When And Why Must The Surety File A Proof of Claim

The proof of claim is the primary means by which the creditor advises the debtor, the trustee, the bankruptcy court, and the debtor’s other creditors of the existence, amount, and type of the creditor’s claim.\(^7\) Filing the proof of claim is not mandatory under the Code and is not necessary in all bankruptcy cases.\(^8\) For example, in a no-asset chapter 7 case, the bankruptcy court generally requests that creditors not file proofs of claim. However, in a chapter 11 case where the surety’s claim is not listed correctly by the debtor on its schedules, or when a deadline (called a “bar date”) is set for filing proofs of claim, the surety must file its proof of claim.\(^9\)

The mechanics of filing a proof of claim are relatively straightforward. The proof of claim should be filed by the date and in the location stated by the bankruptcy court, usually in the Notice of Commencement of Case.\(^10\) The proof of claim can be filed either by the surety directly or by its authorized representative. The proof of claim need not be served on the other parties. The proof of claim should be submitted on the official form provided by the bankruptcy court, which can usually be found on the back of the Notice of Commencement of Case form.\(^11\)

B. What Information Must The Proof Of Claim Include

Most of the information required to complete a proof of claim is fairly routine. The surety must know its own name, address, and claim number. In filling out the proof of claim form, the surety must provide three very important types of information that may be more challenging to determine:

- the amount of the surety’s claim;
- the type of claim being asserted by the surety; and
- a statement as to how the claim arose.

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\(^7\) Another means is through the schedules filed by the debtor at or shortly after the commencement of its case under the Code. If a chapter 11 debtor lists the surety’s claim in its schedule in the correct amount and does not list the claim as disputed, unliquidated, or contingent, then the surety need not file a proof of claim. However, that seldom occurs. Fed. R. Bankr. P. 3003(c)(2) (this rule applies only in chapter 9 and chapter 11 cases).

\(^8\) 11 U.S.C. § 501(a) (creditor may file proof of claim).


\(^10\) See Fed. R. Bankr. P. 3002(c) (in a chapter 7 or chapter 13 case, the proof of claim bar date is usually 90 days after the first meeting of creditors). In a chapter 11 case, the court sets the bar date. Fed. R. Bankr. P. 30003(c)(3).

In determining the amount of the surety's claim, the surety should ignore all other possible sources of recovery. Then, the surety should do a bond-by-bond analysis of the losses incurred and its remaining exposure. The losses incurred total the currently liquidated portion of the surety's claim. The remaining amounts available under the penal sum of each bond outstanding total the surety's contingent liability. Moreover, any fees and expenses recoverable under the General Agreement of Indemnity should also be added, whether liquidated or contingent. The grand total of all of these figures will provide the complete amount of the surety's claim.

The surety's claim must then be categorized and described. These two steps go hand-in-hand. Again, the best way to categorize and describe the claim is to do a bond-by-bond analysis. Generally, it is easiest to do this in a separate document that is attached to the proof of claim because of the minuscule amount of space provided on the proof of claim form. Most importantly when the debtor is the principal, the surety should not just refer to the General Agreement of Indemnity as providing the source for its claim. As will be seen in the second half of this paper, relying solely on the General Agreement of Indemnity may amount to a waiver of all of the surety’s subrogation rights, including rights in contract funds and rights to object to the dischargeability of the debt owed to the surety. In fact, the surety should specifically point out in its proof of claim that it has subrogation rights as described more particularly in the proof of claim and that the surety preserves and asserts those subrogation rights. The surety can also assert a right to reimbursement as to the remaining amount of its loss, after recovery pursuant to its subrogation rights. When the debtor is an indemnitor only, subrogation rights may not exist.

In categorizing and describing its claim, the surety must decide whether it has a “secured” or an “unsecured” claim. Section 506 of the Code provides that an allowed claim of a creditor “secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor’s interest and the estate’s interest in such property.” A “lien” is broadly defined by the Code to mean “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 may give rise to a secured claim. The surety may have a “secured” claim in at least three circumstances. First, if the surety has recorded its General Agreement of Indemnity as a financing statement, the surety may have a security interest in equipment, inventory, accounts receivable, or other property of the debtor. Second, the surety may be secured by any collateral that it is holding. Third, the surety is secured by its subrogation rights, including subrogation rights in contract balances, rights against third parties, and lien rights.

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14 The priority and extent of the security interest granted in the General Agreement of Indemnity will depend upon state law.

15 The surety would be “secured” only if the collateral is property of the debtor not property of a third party such as a letter of credit from a lending institution. See 11 U.S.C. § 506 (creditor must be secured by a lien on property in which the estate has an interest).
The surety must also determine whether it has a “priority” claim. Priority claims are set forth in section 507 of the Code. Generally, the surety that pays a priority claimant is not subrogated to the priority position of that creditor.\(^\text{16}\) However, where the surety issues post-petition bonds and suffers losses thereon or if the surety pays certain administrative expenses of the debtor, the surety’s losses qualify as an administrative expense entitling the surety to first priority. Only in unusual circumstances will the surety have a priority claim.

The bond-by-bond classification and description of the surety’s claim should then be totaled to determine how much of the surety’s claim is secured versus unsecured, how much is priority, and how much is liquidated versus contingent. This information should be filled out on the proof of claim form and timely filed.

C. What Happens After Filing The Proof Of Claim?

A proof of claim executed and filed in accordance with the Bankruptcy Rules is prima facie evidence of the validity and amount of the claim.\(^\text{17}\) After the proof of claim is filed, the surety’s claim is deemed allowed unless a party in interest objects.\(^\text{18}\) There is some dispute as to whether a “party in interest” includes other creditors and the debtor (in a chapter 7 case).\(^\text{19}\) The trustee in a chapter 7 case and the debtor-in-possession in a chapter 11 case are both “parties in interest.” Both are under a duty to examine and object to proofs of claim if a purpose would be served thereby.\(^\text{20}\) The procedure and timing for filing objections is governed by Bankruptcy Rules 3007 and 9014. Moreover, a confirmed plan of reorganization will usually set forth a time within which objections to claims must be filed by the debtor-in-possession and a process for resolution. If an objection is made, the court, after notice and a hearing, determines the amount of the claim.\(^\text{21}\)

The surety’s claim is partially contingent and will no doubt change as the circumstances of the chapter 11 proceeding change. The surety may continue to make payments under its obligations pursuant to the bonds it issued. Therefore, the surety will most likely have to eventually amend its

\(^\text{16}\) See 11 U.S.C. § 507(d). The two exceptions to the Code’s prohibition to subrogation to priority rights relate to administrative expenses under 507(a)(1) or unsecured claims in an involuntary case that arise in the ordinary course of the debtor’s business after the commencement of the case but before a trustee is appointed or an order for relief is entered.

\(^\text{17}\) Fed. R. Bankr. P. 3001(c).


\(^\text{19}\) See generally 3 Collier on Bankruptcy ¶ 502.01 at 502-12 to 502-14 (15th Ed. 1993).


\(^\text{21}\) 11 U.S.C. § 502(b). Section 502(b) sets forth certain items that cannot be approved by the court as part of the claim.
proof of claim. Amendment of proof of claims is not expressly covered by a Bankruptcy Rule, but is common practice.

II. SUBROGATION AND REIMBURSEMENT RIGHTS AND THE BANKRUPTCY CODE.

A. The Treatment Of Subrogation Rights Under The Code

In order to understand the surety’s rights of subrogation and reimbursement and the impact of the Code upon those rights, it is necessary to understand in detail the interplay between sections 502 and 509 of the Code. Generally, the Code preserves to the surety a right of subrogation or reimbursement. The Code does not preserve both rights at the same time for the surety, but requires the surety to decide upon which of the two rights it desires to rely. The surety can choose whether to proceed under subrogation or reimbursement rights on the basis of each particular creditor whose claim the surety has paid.

Any analysis of the surety’s subrogation and reimbursement rights under the Code must begin with a review of section 509 of the Code. Section 509 of the Code provides:

Except as provided in subsection (b) or (c) of this section, 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.

Under the language of section 509 of the Code, in order to assert a subrogation claim, a party must establish the following elements:

1. it is liable with the debtor on;
2. a claim of a creditor against the debtor; and
3. it has paid that claim.

These three elements are different than the tests usually cited to determine whether equitable subrogation exists under applicable state law. There is much disagreement in the case law as to whether section 509 contains the exclusive elements that the surety must prove to assert subrogation rights. The four possibilities are: (1) section 509 sets forth the only elements that need be satisfied in order to prove subrogation; (2) the elements of equitable subrogation under applicable state law are the exclusive elements to prove subrogation under section 509; (3) the elements of section 509


23 In re Photo Mechanical Srvs., Inc., 179 B.R. 604, 618 (Bankr. D. Minn. 1995).


are in addition to those under state law;\textsuperscript{26} or (4) the surety can prove either subrogation under section 509 of the Code or equitable subrogation under applicable state law.\textsuperscript{27} Other courts have touched, but have not ruled, upon the issue.\textsuperscript{28} This confusion among the courts may be important to the surety if applicable non-bankruptcy subrogation law has peculiarities. For example, under federal common law, a surety’s subrogation rights in progress payments may be different from its subrogation rights in retainage.\textsuperscript{29} Under the Code, there is no such distinction. Another example is that most states hold that subrogation is an equitable doctrine that will not be applied unless the surety has an equity superior to the person from whom the surety seeks recovery.\textsuperscript{30} In contrast, section 509, at least by its terms, is fairly mechanical in application and would not appear to require any balancing of the equities. Nonetheless, in most circumstances, the surety can establish subrogation rights under state law and section 509 without undue burden.

Several courts requiring that the surety prove the elements of section 509 of the Code and the elements of subrogation under state law hold that “in addition to the explicit requirements under section 509(a), it is well settled that the alleged subrogee must not have acted as a volunteer in making the payment and the debt paid must be one for which the alleged subrogee was not primarily liable.”\textsuperscript{31} However, other courts have expressly rejected the requirement that the party seeking subrogation rights not be “primarily liable.”\textsuperscript{32} The issue goes to the question of whether a surety is “primarily” or “secondarily” liable with the debtor on its obligations under the bond. The surety can be viewed as having a primary liability under the terms of its bond or a secondary liability that is derivative from the contract liability of the debtor/principal to the bond claimant. The question is answered differently in different jurisdictions. Under its terms, section 509(a) does not require an analysis of whether the surety’s liability is primary or secondary. Rather, section 509(c) requires that

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  \item \textsuperscript{26} 

  \item \textsuperscript{27} 

  \item \textsuperscript{28} 
  Feldhan v. Feldhan, 929 F.2d 1351 (8th Cir. 1991); Photo Mechanical, 179 B.R. at 619.

  \item \textsuperscript{29} 
  Balboa Ins. Co. v. United States, 775 F.2d 1158, 1163 (Fed. Cir. 1975).

  \item \textsuperscript{30} 

  \item \textsuperscript{31} 

  \item \textsuperscript{32} 
\end{itemize}
the party asserting subrogation rights must not have received the consideration for the claim paid. This statutory requirement would seem on its face to avoid any need to inquire as to “primary” versus “secondary” liability under state law. In fact, the question of who receives the consideration for the claim asserted by the creditor is exactly the same issue that state law attempts to address when it requires that the party asserting subrogation rights not be primarily liable on the debt. The idea is that the surety, and not the principal, be entitled to assert subrogation rights. In light of the prohibition in section 509(c) from the party that receives the consideration for the debt asserting subrogation rights, a requirement in addition to the elements of section 509(a) that the surety not be primarily liable on the debt would seem to be superfluous.

One commentator has added a new dimension to the question of whether section 509(a) provides the exclusive elements to subrogation under the Code or whether resort to state law is necessary. The following analysis is derived from Collier on Bankruptcy, a leading treatise on the Code. The analysis begins with a literal reading of section 509 of the Code. Section 509 applies where the surety is liable with the debtor on or has secured a claim of a creditor against the debtor. Both "claim" and "creditor" are defined terms under the Code. In order to be a "creditor" under the Code, one must have a "claim" against the debtor. Thus, the use of the words "claim" and "creditor" in section 509 of the Code may limit the applicability of section 509 to situations where the surety's payment is made post-petition. Where the surety makes payment to the creditor pre-petition, the bond claimant does not have a "claim" against the debtor and is not a "creditor" of the debtor under the definitions employed by the Code. Where payments are made pre-petition, the surety's subrogation rights arise not under section 509 of the Code, but rather under state law. Collier states:

If a co-debtor discharges a debt in full prior to the filing of a petition, section 509(a) is inapplicable. As a rule, the rights of the creditors relate to the date of the filing of the petition. If the debt has been fully discharged by the co-debtor prior to the filing date, the original creditor is satisfied and, through subrogation outside of bankruptcy law, replaced by the co-debtor. The latter is the only person able to qualify as a creditor on the filing date. The original creditor would not be entitled to prove a claim even if he wished to do so because none is owing. Since section 509(a) deals only with the subrogation rights of a co-debtor, it cannot very well be said to apply to a situation in which there is no creditor, other than the co-debtor himself, entitled to the claim. A co-debtor who has satisfied the

33 A creditor is defined as:

(A) entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor;

(B) entity that has a claim against the estate of a kind specified in section 348(d), 502(f), 502(g), 502(h) or 502(i) of this title; or

(C) entity that has a community claim.


34 3 Collier on Bankruptcy ¶ 509.02 at 509.6 to 509.7 (15th Ed. 1993).
As can be observed from the passage quoted, the only authority cited by
Collier in support of the conclusion that a full prepetition satisfaction of a
claim against the debtor by a co-obligor eliminates the application of
§ 509(a) is In re Burka, 104 F. 326 (E.D.Mo. 1900). Burka involved a
claim of an attorney who had performed services for a debtor post-
petition. The court there held, interpreting the Bankruptcy Act of 1898 at
a time when it was newer than the Bankruptcy Code of 1978 is today,
that the debt to the attorney was no “provable” and hence no claim for it
could be maintained in the bankruptcy because the claim did not exist on
the date of the filing of the petition. Id. at 327.

It appears to us that the analogy between the Burka situation, which is
dealt with by the present Bankruptcy Code under entirely different
principles in 11 U.S.C. §§ 327, 330, and a claim of subrogation pursuant
to § 509(a), is very weak. The claims of the Claimants here not only
existed, but whatever secured status they had was established, prior to
the date of the bankruptcy filing, unlike the claim at issue in Burka. There
seems to us no logical basis, nor any basis in the statute, to treat
subrogation rights which arise as a result of a full pre-petition payment of
a joint obligation by a co-obligor differently than those created by partial
pre-petition payment. The only practical difference arising from a full pre-
petition payment of the joint obligation by a co-obligor is that the original
secured creditor would no longer remain a creditor of the debtor at the
time of filing. Why this fact would or should be significant in determining
subrogation rights of the co-obligor who makes the payment is totally
unclear to us.

Our inability to perceive full pre-petition payment by a co-obligor claiming
subrogation rights as a basis for holding § 509(a) inapplicable is shared
by other courts. In In re Bugos, 760 F.2d 731, 734 n. 4 (7th Cir. 1985),
the Court of Appeals expressly states that “[t]he equitable principle of
subrogation applies to the satisfaction of debts by a co-debtor prior to
bankruptcy as well as to the post-petition satisfaction of debts.” Among
the decisions cited by Bugos as consistent with this principle are those of
another Court of Appeals, In re Missionary Baptist Foundation of
America, Inc., 667 F.2d 1244, 1245-47 (5th Cir. 1982), and of former
Chief Judge Emil F. Goldhaber of this court, In re Alloway, 37 B.R. 420,
423 (Bankr. E.D. Pa. 1984). Numerous other cases, without expressly

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Sensor Systems has either been criticized by or followed by other courts as part of a split among the case law
regarding whether the issuer of a letter of credit posted as collateral for a particular obligation is entitled to
subrogation rights. The dispute in the case law on that issue is not directly relevant to the question being
discussed herein.
discussing the point, reach the same result. See generally, In re N&D Properties, Inc., 54 B.R. 590, 599-600 (N.D. Ga. 1985); In re Zoglman, 78 B.R. 213, 214-15 (Bankr. W.D. Wis. 1987); In re Miller, 72 B.R. 352, 353-54 (Bankr. W.D. Pa. 1987); and In re Parker, 10 B.R. 562, 565 (Bankr. M.D. Ala. 1981). On the other hand, we have located no cases at all which support the reasoning of Collier, either expressly or by implication.

In summary, section 509 of the Code preserves subrogation rights to the surety. However, applicable non-bankruptcy law and its treatment of subrogation rights is still important to the surety. To be safe, the surety should still comply with any requirements of applicable non-bankruptcy law. Section 509 of the Code grants subrogation only to the rights of the particular creditor paid by the surety and then only to the extent of the payment. Moreover, section 509(e) of the Code only disallows the right of reimbursement “to the extent that” the surety asserts a right of subrogation to the rights of the creditor whose claim it paid. Thus, the surety can decide on the basis of each creditor whose claim it paid whether the surety wants to assert a subrogation right or a reimbursement right for the payment made to that particular creditor.

B. Subrogation And Non-Dischargeability

Section 509(a) provides that the surety is subrogated "to the rights of such creditor." The Code does not enumerate or limit the rights to which the surety is subrogated. The cases uniformly hold that the surety is subrogated to rights created by applicable non-bankruptcy law, including rights in contract funds, lien rights, and claims against third parties such as design professionals. The surety would also be subrogated to the creditor's rights under the Code, including the right to vote on a plan of reorganization, to be heard on various issues, to participate in committees, and similar rights. But in terms of the administration of the debtor's bankruptcy case, perhaps the most significant right to which the surety can be subrogated is the right to object to the dischargeability of the debt owed by the debtor to the creditor whose claim the surety paid.

Section 523 of the Code provides that certain debts owed by the debtor are not discharged in bankruptcy. Nothing in section 523 prohibits subrogation or limits the persons entitled to bring a nondischargeability action. The courts have universally interpreted section 509 of the Code as allowing a surety to assert subrogation to claims of nondischargeability.

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37 The exceptions to discharge most relevant to the surety are for money obtained by false pretenses or actual fraud, other than a statement respecting the debtor’s or an insider’s financial condition, 11 U.S.C. § 523(a)(2)(A), for money obtained by the use of a false financial statement, 11 U.S.C. § 523(a)(2)(B), or for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny, 11 U.S.C. § 523(a)(4).

38 In re Covino, 12 B.R. 876, 877 (Bankr. M.D. Fla. 1981). However, section 523(a)(5)(A) prohibits a claim of a nondischargeability for alimony, maintenance, or support by an assignee. Had Congress intended to prohibit claims of nondischargeability under sections (a)(2) and (a)(4) by assignees or subrogees it could have and should have done so explicitly as it did with subsection (a)(5).
An excellent discussion of subrogation and nondischargeability issues is contained in the bankruptcy court’s decision in In re Richardson.39 There, the surety issued a trustee’s bond in favor of an attorney who was appointed by the court to sell a piece of property and apportion the proceeds among the tenants in common. However, the debtor decided to use the trust proceeds to pay himself unapproved attorney’s fees and expenses. Judgment was entered against the trustee and the surety and the surety made payment. Thereafter, the debtor filed a petition for relief under the Code and the surety timely objected to the discharge of the debt owed to it. The trustee raised numerous arguments in defense of the surety’s claims, but the main argument was that the surety was not subrogated to the rights of the trust beneficiaries to object to the dischargeability of the debt owed by the debtor. In holding that the surety was subrogated to the right to object to the discharge of the debt, the court noted:

The general rule of subrogation is that the subrogee stands in the shores of the prior claim holder, and as such, “is substituted to all rights and remedies” of the prior claim holder as thought the subrogee were the prior claim holder. Black's Law Dictionary 1595 (4th ed. 1968). Accordingly, whether the plaintiff had a fiduciary relationship with the debtor is irrelevant. Rather, the analysis should focus on whether the prior claim holders, the trust beneficiaries, the plaintiff would be entitled to all the rights and remedies against the debtor that the trust beneficiaries could have asserted.

Similarly, the debtor in this case would be responsible after bankruptcy for a nondischargeable claim under § 523(a)(4). The public policy behind the exceptions to discharge for breach of fiduciary duty is punitive in nature and intended to discourage improper conduct, ensuring that relief intended for honest debtors does not inure to the benefit of the dishonest. See generally, In re St. Laurent, 991 F.2d 672, 678-79 (11th Cir. 1993); Birmingham Trust Nat. Bank v. Case, 755 F.2d 1474, 1477 (11th Cir. 1985); In re Hunter, 771 F.2d 1126, 1130 (8th Cir. 1985). This intent would be easily frustrated if the debtor in this case were simply able to avoid the liability by allowing the surety to cover the debt and then discharging the debt to the surety in bankruptcy.40

Other cases reach a similar result. In Covino, an employee improperly withdrew funds from the employer’s account for the employee’s own benefit. Pursuant to its obligation under a fidelity bond and insurance policy, the surety reimbursed the employer for the loss suffered. In the employee’s subsequent bankruptcy case, the surety objected to dischargeability of the debt owed by the employee to the surety. The court held that the “dischargeability of this debt, which unquestionably initially arose as a result of the debtor’s embezzlement, should not depend on whether the employer had the foresight to purchase insurance.” Id. The court held that the surety on the fidelity bond was subrogated to the employer’s rights to object pursuant to section 523(a)(4) to the dischargeability of the debt.


40 178 B.R. at 23.
In *In re Morris*, a licensee objected to the dischargeability of a debt owed by a sub-licensee debtor. The court found that the sub-licensee obtained money and property from the licensor through fraud and conversion and that the debt would be nondischargeable under subsections (a)(2)(A) and (a)(6), had the action been brought by the licensor. Pursuant to certain contractual guarantee obligations, the licensee had satisfied the obligations owed by the sub-licensee to the licensor. The court noted that the licensee was subrogated to the licensor's claim against the sub-licensee debtor. "As subrogee, plaintiff is entitled to a finding of nondischargeability in the same manner and effect as is its assured [the licensor]." 31 B.R. at 478. The court held that "the weight of authority holds that where a surety pays a nondischargeable obligation of its principal, the surety is subrogated not only to the assured's claim against the principal, but to the nondischargeable quality of the obligation as well." Id. Therefore, the debt owed by the sub-licensee debtor to its surety was nondischargeable.

Numerous cases have held that a secondarily liable party (such as a surety) who satisfies a nondischargeable tax obligation is subrogated to the taxing authority's right to object to the discharge of the debt. In *In re Norris*, the court stated that it "will follow the majority rule that a surety's subrogation to the government's tax claim includes the right to have the debt excepted from discharge." 107 B.R. at 595. The court held that the surety that paid the debtor's nondischargeable tax debt to the state was subrogated to the state's right to have the debt held nondischargeable.

In *In re Gibbs*, the court held that "the surety is subrogated to the rights of the creditor whose claim it pays and the surety's right to reimbursement is of the same character as the creditor's claim." Therefore, the surety that paid nondischargeable taxes was entitled to claim that the debt owed to

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42 See also *In re Dynda*, 19 B.R. 817, 818-19 (Bankr. M.D. Fla. 1982) (fire insurer, which paid insured for damages incurred by reason of fires started by the debtor, was granted an exception to the discharge under subsection (a)(6) by reason of the insurer's subrogation rights); *In re Snellgrove*, 15 B.R. 149 (Bankr. S.D. Fla. 1981) (debt owed to surety by individuals who diverted funds from bonded projects was nondischargeable under subsection (a)(4) by reason of the surety's subrogation to the rights of laborers and materialmen under the Florida mechanic's lien law).

43 The Code expressly provides that the surety is not subrogated to the priority position of the taxing authority. 11 U.S.C. § 507(d). The limitation on priority of subrogated claims under section 507(d) is a narrow exception to the general rule in favor of subrogation. The right of nondischargeability is separate and distinct from the right of priority and the fact that Congress chose to expressly limit the reach of subrogation in the priority context is evidence of its intent not to limit it in the nondischargeability context unless it used clear and express language so limiting the right. See *Richardson*, 178 B.R. at 24 and n. 3.


the surety was nondischargeable. 11 B.R. at 322. The court in In re Alloway, held that "under the Code, one who pays the tax claim of another may be subrogated to the right of the taxing authority to seek an exception to discharge."46

C. Subrogation v. Reimbursement - The Surety Cannot Have It Both Ways

The grant of subrogation rights is not without exception. Section 509(b) of the Code provides:

Such entity [e.g., the surety] is not subrogated to the rights of such creditor to the extent that---

(1) a claim of such entity for reimbursement or contribution on account of such payment of such creditor's claim is---

(A) allowed under section 502 of this title;

A surety 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.”49 The danger for the surety arises where it files a proof of claim asserting reimbursement rights only, such as reimbursement rights under the General Agreement of Indemnity. Section 502 provides that proofs of claim filed under section 501 are deemed allowed unless there is an objection.50 If the surety files a proof of claim for reimbursement rights and no objection is made by the debtor, the surety is deemed to have an allowed claim under section 502 of the Code without further action. Pursuant to section 509(b),


47 See also In re Fields, 926 F.2d 501, 504 (5th Cir.), cert. denied, 112 S. Ct. 371 (1991); In re Waite, 698 F.2d 1177, 1178 (11th Cir. 1983); Gilbert v. United States Fidelity & Guar. Co., 274 F.2d 823 (5th Cir. 1980); In re Rose, 139 B.R. 878, 881-83 (Bankr. W.D. Tenn. 1992); In re Trasks' Charolais, 84 B.R. 646, 652 (Bankr. D.S.D. 1988); In re Cooper, 83 B.R. 544, 548 (Bankr. C.D. Ill. 1988); In re Zoglman, 78 B.R. 213, 214 (Bankr. W.D. Wis. 1987); In re Caffrey, 77 B.R. 219, 221 (Bankr. W.D. Mo. 1987); In re Hancock, 36 B.R. 709, 710 (Bankr. S.D. Ill. 1984). The only case taking a contrary view has been universally rejected by every other court to consider the issue. See National Collection Agency, Inc. v. Trahan, 624 F.2d 906 (9th Cir. 1980) (subrogation to nondischargeability claim for payment of taxes under the Bankruptcy Act denied for policy considerations). With the enactment of section 509(a) of the Code, the decision in National Collection is effectively overruled. See Richardson, 178 B.R. at 24; Rose, 139 B.R. at 882.


49 Richardson, 193 B.R. at 380.

if it has an allowed reimbursement claim, the surety loses its subrogation rights. Thus, filing a proof of claim based on the indemnity provisions of the General Agreement of Indemnity can lead without any further action to a waiver of the surety’s subrogation rights.

While it is possible that the court would allow the surety to assert its subrogation rights despite contrary language in the proof of claim, it is a risky proposition. The better course is to expressly reserve the subrogation rights in the proof of claim. For example, on the appeal to the District Court in Richardson, the debtor argued that the surety elected to proceed on its reimbursement rights and therefore waived its subrogation rights and was not entitled to a determination that the debt owed was nondischargeable. The proof of claim filed by the surety expressly provided: “[surety] asserts no claim in its own right, but only asserts this proof of claim as subrogee of the [creditors whose claims the surety paid]”. Because the surety affirmatively asserted only subrogation rights and did not have an allowed claim for reimbursement or contribution, the surety was entitled to a determination that the debt owed was nondischargeable. However, if the surety had not expressly reserved its subrogation rights and had filed its proof of claim based on reimbursement rights, the debtor may have prevailed and the debt discharged.

In summary, section 509(b)(1) applies only where there is an allowed claim for “reimbursement or contribution.”53 As long as the proof of claim provides that the surety is relying upon and asserts its subrogation rights pursuant to section 509 of the Code, there is no election.54 Otherwise, the possible draconian result is that the surety loses all of its subrogation rights, including rights in contract funds.

D. Other Exceptions To Recognition Of Subrogation Rights Under The Code

In addition to requiring the surety to elect between subrogation and reimbursement rights, section 509(b) also provides that the surety is not subrogated to the rights of the creditor whose claim the surety paid if the creditor’s claim is:

1. (B) disallowed other than under section 502(e) of this title; or
2. (C) subordinated under section 510 of this title; or

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51 In re Watkins Oil Service, Inc., 100 B.R. 7, 12 (Bankr. D. Az. 1989) (where guarantor filed a proof of claim, but later asserted its right to subrogation, the court disallowed the claim for reimbursement but allowed the creditor to assert subrogation rights).

52 193 B.R. at 381.

53 Section 509(b)(1)(A) applies only in the event that a co-debtor’s claim for reimbursement or contribution based on the co-debtor’s payment of the creditor’s claim, is allowed under section 502, as discussed above. In such event, section 509(b)(1)(A) precludes subrogation of the co-debtor to the extent of such allowance. 3 Collier on Bankruptcy ¶ 509.03 at 509-9 (15th Ed. 1993).

54 See In re Trasks’ Charolais, 84 B.R. 646, 650 (Bankr. D. S.D. 1988) (where co-debtor filed proof of claim asserting a right of subrogation, co-debtor was entitled to subrogation rights notwithstanding section 509(b)).
(2) as between the debtor and such entity, such entity received the consideration for the claim held by such creditor.\textsuperscript{56}

This section disallows subrogation rights when the surety’s claim is disallowed other than under section 502(e), which is generally for one of the reasons set forth in section 502(b) or because of other state law defenses to the surety’s claim. Thus, if the surety is not entitled to recover money from the debtor, the surety is not entitled to assert subrogation rights. Subordination of the surety’s claim would only occur in the egregious circumstances entitling the debtor to subordinate a claim under section 510 of the Code.

Section 509(a) requires that for the surety to be subrogated it must have paid the creditor’s claim \textit{in full}. Section 509(c) provides: \textsuperscript{56}

The 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.

Thus, section 509(c) serves to subordinate the surety’s subrogation right until the creditor’s claim is not just paid as required by section 509(a), but paid \textit{in full}. This may present trouble for the surety in two circumstances. The first is when the creditor has claims on both bonded and unbonded jobs. Where the surety pays the claims on the bonded jobs but does not make payment on the unbonded job, the creditor’s “claim” as defined under the Code has not been paid in full. One reading of section 509(c) could prohibit the surety from asserting subrogation rights in remaining contract balances because of unpaid bills on an unbonded job. However, section 509(c) operates only against an entity that is liable with the debtor on the claim. The surety should argue that it is not liable with the debtor on the remaining portion of the creditor’s claim and is therefore entitled to assert subrogation rights. The second circumstance would be where the surety has a payment bond that is in an amount insufficient to satisfy the total payment bond claimants on the project, such as the Miller Act 50% payment bond. Where the surety pays its penal sum of the payment bond pro rata among the payment bond claimants, but does not pay any particular payment bond claimant in full, a literal reading of section 509(c) would prohibit the surety from asserting subrogation rights in the remaining contract balances until those payment bond claimants are paid the remaining amount of their claim unless the surety also suffered a performance bond loss. The author has found no cases addressing either of these factual situations under the Code.

E. Exceptions To Recognition Of Reimbursement Rights Under The Code.

Section 502(e) provides: \textsuperscript{57}

\textsuperscript{55} 11 U.S.C. § 509(b). Section 509(b)(2) would generally be inapplicable in the suretyship context because it is the principal, not the surety, that receives the consideration for the creditor’s claim. Therefore, this paper will focus on the conditions in section 523(b)(1).

\textsuperscript{56} 11 U.S.C. § 509(c).

\textsuperscript{57} 11 U.S.C. § 502(e)(1).
(e)(1) 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 an entity that is liable with the debtor on or has secure the claim of a creditor, to the extent that---

(A) such creditor’s claim against the estate is disallowed;

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

(C) such entity asserts a right of subrogation to the rights of such creditor under section 509 of this title.

Section 509(b) limits the surety’s subrogation rights in certain contexts; section 502(e) limits the surety’s reimbursement rights in parallel circumstances. Under section 502(e), the court must disallow the surety’s claim for reimbursement to the extent that the original creditor’s claim against the estate is disallowed, the claim for reimbursement remains contingent throughout the bankruptcy proceedings, or where the surety asserts its right of subrogation. Generally, it is the first of these three circumstances that may give the surety difficulty. If a creditor, such as a bond claimant, fails to timely file its proof of claim, its claim may be disallowed by the bankruptcy court. However, if that creditor still brings a timely suit against the surety, the surety may be obligated to pay the claim. Because the creditor’s claim against the bankruptcy estate would be disallowed, the surety’s reimbursement right may similarly be disallowed. This result can be avoided if the surety timely files a contingent proof of claim in the full penal sum of its bonds. In that circumstance, the timeliness of the creditor’s claim would be irrelevant and the surety could argue that its proof of claim, while contingent when originally filed, has become fixed after the commencement of the case and should be allowed pursuant to section 502(e)(2).

The second exception to the surety’s reimbursement rights will only disallow contingent reimbursement claims where the surety’s liability does not become fixed during the pendancy of the bankruptcy case. The third exception is another statement of the proposition that the surety cannot assert both subrogation and reimbursement rights with regard to a particular payment to a bond claimant.

**CONCLUSION**

Even though filing a proof of claim may seem to be a relatively straight-forward procedure, the surety must take care to preserve its subrogation rights in the proof of claim. The Code specifically grants to the surety a right of subrogation in most circumstances. Protecting and pursuing the rights of subrogation will allow the surety to effectuate its three primary objectives in the bankruptcy context: (1) seeking reimbursement from the debtor to the extent permitted under the Code; (2) protecting its subrogation rights; and (3) preventing the discharge of the debt owed to it by the debtor in appropriate circumstances. It is important to note that the rights of reimbursement and subrogation can be pursued simultaneously; the rights cannot be pursued simultaneously with regard to the same bond payment. However, the surety must protect its rights to pursue subrogation or reimbursement, whichever is more favorable to the surety, in its proof of claim or lose the rights forever.

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