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## The Impact of Bankruptcy on Terminating Surety and Fidelity Bonds

### Written by:

Bruce W. Hoover<sup>1</sup>  
Goldberg Segalla, LLP; Buffalo, N.Y.  
bhoover@goldbergsegalla.com

Sureties believe that their risk of exposure significantly increases when a principal becomes insolvent or files for bankruptcy protection. As a result, sureties often seek to terminate their surety or fidelity obligations upon the principal's insolvency or bankruptcy. The disposition and implications of a surety's bond(s) where the principal has filed bankruptcy can be difficult to assess, since the Bankruptcy Code was not necessarily drafted with specific consideration for surety bonds, but rather the general rights and benefits necessary for debtors and creditors in general.

This article discusses the issues a surety or fidelity must analyze in connection with seeking to terminate its surety and fidelity obligations upon the insolvency or bankruptcy of its principal. These issues include the interplay between the rights of a surety or fidelity under the terms of the applicable bond and rights of debtors under the Code.

Many surety and fidelity bonds give the surety the right to terminate the bond. Some typical provisions include the following:

- *Sample Language No. 1.* This bond may be terminated by the surety by written notice of its intention to do so filed in the Office of the Labor Commissioner, and by giving written notice thereof to the principal in which event the surety's liability shall terminate at the expiration of 90 days from the date of such filing and not earlier. However, such termination shall not relieve the surety of its continuing liability under this bond for obligations that accrued prior to the effective date of such termination.

### About the Author

*Bruce Hoover is a partner with the firm of Goldberg Segalla LLP, where he concentrates his practice on commercial transactions and representing creditors and sureties in enforcing and protecting their rights in bankruptcy and other civil proceedings.*

- *Sample Language No. 2.* This bond may be terminated as of and on a specified date by the surety by and in written notice of termination delivered to the director of the Workers' Compensation Administration, and given by certified mail to the principal. Such termination shall not be effective, however, unless the specified date thereof occurs at least 30 days after the date of such filing and mailing and not earlier. The liability of the surety shall nevertheless continue as to any and all obligations of the principal

## Feature

as a self-insured employer under the Workers' Compensation Act arising out of compensable accidents occurring prior to the effective date of termination, subject, however, to termination of all liability of the surety under this bond, upon the director's acceptance of any acceptable replacement bond or security from or on behalf of the principal.

- *Sample Language No. 3.* Either the principal or the surety may cancel the obligation under this bond, but such cancellation will only be effective if the surety mails a notice of such intent to cancel, by registered or certified mail, with return receipt requested, to the commissioner at least 90 days prior to the

cancellation date specified in the notice. In such event, the obligations of the surety shall cease at the close of business on the cancellation date specified in the notice as to any future acts, activities or failures or refusals to act of the principal but not as to any acts, activities or failures or refusals to act occurring before the close of the business on such 90th day.

- *Sample Language No. 4.* This bond shall terminate with respect to any employee on a date specified in a written notice given by the obligee to the surety, or in a written notice of at least 30 days given by the surety to the obligee. In the event of any termination of the foregoing clause, the surety shall refund the unearned premium on demand.

Each of these provisions enables a surety to terminate its obligation prospectively upon some form of notice to the principal and/or obligee. Typically, upon notice of termination, the obligations of the surety are limited to obligations

that existed or accrued up until the time of termination. The termination applies only to prospective obligations. Absent a bankruptcy filing by a principal, the surety is free to exercise its right of termination. Absent a specific provision in the bond, the surety has little recourse to terminate its bond upon the insolvency of the principal.

Once a principal files for bankruptcy, a surety has several issues to evaluate to assess termination of its bond. Does the bond have provisions for termination? If the bond has provisions for termination, the surety must then assess what provisions of the Code, if any, impact the ability or procedure of the surety to exercise its right to terminate. If the bond does not

<sup>1</sup> The author thanks Christopher J. Belter and Joseph M. Hanna for their invaluable assistance on this article.

contain provisions for termination of a bond at any time on notice, the bankruptcy of the principal may actually provide the surety with an opportunity or leverage to terminate the bond or to improve the surety's position vis-à-vis the principal.

There are many provisions of the Code that come into play with respect to sureties and their bonds upon the bankruptcy of their principals. For purposes of this article, §§362, 365 and 541 are considered as they relate to the rights of a surety and/or debtor to assume, reject or terminate a bond. (In addition, §§361, 363, 364, 501, 502, 503, 506, 547, 550, 552 and 553, among others, may be relevant to a surety and its bond(s).) Under §362(b) of the Code, parties are automatically stayed from commencing any proceeding against the debtor or taking any action with respect to property of the bankruptcy estate (as defined in §541) after the filing of a bankruptcy petition. The question then posed is whether or not the act of a surety to terminate its bond constitutes an act in violation of the automatic-stay provisions of §362. In addition to the benefits of the automatic stay, §365 allows debtors to assume or reject certain executory contracts.

Very few cases have addressed a surety's efforts to terminate its bond after a principal has filed for bankruptcy. In *Wegner Farms Company v. Merchants Bonding Co.*, 49 B.R. 440 (Bankr. N.D. Iowa 1985), the debtor, Wegner Farms Co., filed a voluntary chapter 11 petition. The debtor was a grain dealer licensed by the State of Iowa. As part of its requirements to be a licensed grain dealer, the debtor had obtained a bond from Merchants Bonding Co. in the penal sum of \$25,000 for the benefit of companies buying grain from or selling grain to the debtor. Under Iowa law and the terms of the bond, the bond was to remain in full force and effect until canceled by the surety. At the time of the bankruptcy filing, the penal sum of the bond was \$50,000. Bond premiums were paid on an annual basis, and at the time of the bankruptcy filing the debtor was not in arrears on its premium payments. Subsequent to the filing of the bankruptcy petition, Merchants sent a notice of termination to the debtor notifying the debtor that the bond would be canceled effective March 17, 1985, and that the debtor's grain dealer license would be revoked by operation of law unless notice of a replacement bond was received by the state before that date. The question before the court was whether Merchants' unilateral termination of the bond post-petition violated the automatic stay.

Citing §§362(a)(1) and 362(a)(3), the court held that Merchants' unilateral actions did violate the automatic stay. Specifically, the court found that Merchants' efforts to cancel the bond constituted a "proceeding" against the debtor within the meaning of §362(a)(1). The court also found that Merchants' notice of cancellation of the bond violated §362(a)(3), which prohibits "any act to obtain possession of property of the estate...or exercise control over property of the estate." *Wegner* at 443. With respect to its interpretation of §362(a)(3), the court noted that §541(a), defining property of the estate, is extremely broad in scope. The court stated:

The bonding agreement was a valid contract entered into by Merchants and the debtor. Even though the payment obligation ran to the third parties doing business with debtor as a grain dealer, debtor's coverage under the bond was a contractual obligation bargained for by the debtor and for which it paid valuable consideration. It defies logic to say that debtor as the named principal under bond and the payer of the premium for the coverage provided by the bond, had no legal or equitable interest in the bonding agreement. Quite the contrary, the debtor had valuable contractual rights in the bonding agreement on the date of filing. Contractual rights constituted tangible property which is included within the definition of property of the estate. Consequently, Merchants' unilateral termination of the agreement post-petition was an attempt to obtain possession of property of estate in controversy of Section 362(a)(3).<sup>2</sup>

The *Merchants* court distinguished a series of cases in which courts had held that surety bonds were not property of the estate, including *In re Apache Construction Inc.*, 34 B.R. 415 (Bankr. D. Or. 1983). The court in *Merchants* stated that, "to the extent those cases can be read as merely holding that a Debtor has no interest in the penal sums intended for the benefit of the third party claimants, this Court passes no judgment. To the extent, however, these decisions can be construed as holding that debtor as a contracting party to the bonding agreement has no legal or equitable interest in the contract, the Court concludes that they are incorrect as a matter of law."<sup>3</sup>

The court then went on to address Merchants' argument that even if the bonding agreement was property of the estate, it is a financial accommodation of

the kind described in §365 that, according to Merchants, allowed Merchants to cancel its obligations under the bond without seeking relief from the automatic stay. Under §365(e)(2)(b), an executory contract to make a loan or extend other debt financing or financial accommodations, to or for the benefit of the debtor, is exempted from the general rule that prohibits cancellation or termination of contracts because of a provision in the contract providing for termination upon the insolvency or the filing of bankruptcy. Executory contracts that are financial accommodations may not be assumed or assigned by the debtor, as set forth in §365(c). The court noted that while a surety bond does not fit squarely within the framework of traditional debt financing, the court concluded that the bond was a financial accommodation within the meaning of §§365(c) and 365(e). As such, the court stated that a bond cannot be assumed by a debtor and can be terminated because of a debtor's bankruptcy. However, the court went on to reason that even though a bond is a financial accommodation that could not be assumed by the debtor, the right of termination in favor of the surety does not allow the surety to circumvent the provisions of the automatic stay. The only authority cited by Merchants in support of its right for unilateral termination, which the court did not accept or agree with, was *Collier on Bankruptcy* ¶[365.05][1] (15th ed. 1985), which provided, in relevant part: "Presumably the automatic stay of section 362, which prohibits a creditor from terminating or accelerating after the petition, will not apply to these special kinds of contracts or leases."<sup>4</sup>

In *Wegner*, the decision of the court did not cite or quote the exact provision of the bond by which Merchants sent its notice of cancellation. However, it appears that the provision was similar to the provisions first referenced in this article, which are common for bonds of this nature. The provisions in bonds of this nature giving the surety the right of termination are not conditioned upon the insolvency or bankruptcy of the principal, but the unilateral right to cancel at any point in

<sup>3</sup> *Id.* There are a number of cases that hold that a debtor does not have an interest in bonds issued to guarantee obligations of a debtor. See, generally, *In re Lockard*, 884 F.2d 1171 (9th Cir. 1989), and cases cited therein in support of the proposition, generally involve a creditor who has commenced an action against a third-party guarantor or surety. The courts hold that the instrument sued upon is not property of the estate and that relief from the stay by the creditor is generally not necessary. As the *Wegner* court noted, none of these cases involved a surety seeking to terminate debtor's complete interest in the bond.

<sup>4</sup> At least one treatise has indicated that there is authority in the Ninth Circuit to the effect that to end a financial accommodation, there is no need to lift the automatic stay. Duncan Clore, Richard Towle and Michael Sugar, eds., *Bond Default Manual* (3d ed., American Bar Association 2005) at 350.

<sup>2</sup> *Wegner Farms Company v. Merchants Bonding Co.*, 49 B.R. 440, 443 (Bankr. N.D. Iowa 1985).

time without regard to any condition or specific event. Accordingly, the right of the surety to terminate should not be impacted by the bankruptcy of the debtor, except to the extent the surety must first obtain relief from the automatic stay. The provisions of §365(e) are limited to provisions in contracts of financial accommodation that are conditioned upon the insolvency or bankruptcy of the debtor. Therefore, bonding companies, such as Merchants and others, should be free to exercise the notice of cancellation at any time post-petition, subject to seeking relief from the automatic stay.

Likewise, in *Edwards Mobile Home Sales Inc. v. Ohio Casualty Insurance Co.*, 119 B.R. 857 (Bankr. M.D. Fla. 1990), the chapter 11 debtor sought to enjoin a bonding company, Ohio Casualty, from revoking a surety bond and from preventing the state from revoking the debtor's license to sell mobile homes. In that case, the court held that even though the surety bond issued to the debtor was a financial accommodation within the meaning of the Code, the bonding company was required to seek relief from the automatic stay before terminating the bond. The court also noted that the state's subsequent revocation of the debtor's mobile home dealers' license came within the exception to the automatic stay for governmental actions taken to enforce police or regulatory powers. In that case, the debtor filed for bankruptcy protection on Jan. 3, 1990. On March 26, 1990, Ohio Casualty sent a cancellation notice of the debtor's surety bond to the State of Florida. The State of Florida advised the debtor that its license to sell mobile homes would be revoked unless a replacement surety bond was secured.

In its decision, the court first addressed whether Ohio Casualty's surety bond was a financial accommodation defined under §365(c)(2). The court, citing *Wegner*, held that the bond was a financial accommodation and that the surety bond could not be assumed under the other provisions of §365. With respect to Ohio Casualty's right to unilaterally terminate the bond, the court agreed with the reasoning in *Wegner* and held that Ohio Casualty was not allowed to unilaterally terminate the bond, but rather was required to first seek relief from the automatic stay under §362. The court found that Ohio Casualty's mailing of the cancellation notice was a violation of the automatic stay and set an evidentiary hearing to determine damages and sanctions appropriate under §362.<sup>5</sup>

In *In re Adana Mortgage Bankers Inc.*, 12 B.R. 977 (Bankr. N.D. Ga. 1980), and in a companion case, *In re Adana Mortgage Bankers Inc.*, 12 B.R. 989 (Bankr. N.D. Ga. 1980), the court held that the obligation to pay sums of money by Government National Mortgage Association (GNMA), pursuant to various guaranty agreements on the obligation of Adana Mortgage Bankers Inc., was a financial accommodation under §365(c)(2), and accordingly, GNMA was authorized pursuant to the terms of the guaranty agreements to terminate them post-petition. The court rejected GNMA's argument that its right to terminate the guaranty agreements relieved it from the provisions of the automatic stay and held GNMA in contempt for unilaterally terminating the agreements post-petition. In those cases, GNMA was financially responsible pursuant to various guarantee agreements with Adana to pay certificate-holders of mortgage-backed securities if Adana failed to make payments to them in connection with the mortgage-backed securities. The court found GNMA's guaranty agreement to be a financial accommodation and, therefore, a non-assumable executory contract. Further, pursuant to §365(e)(2), contracts to make financial accommodations may be terminated upon insolvency, bankruptcy or other financial defaults, unlike other types of executory contracts. The provision relied upon by GNMA to terminate its financial accommodation provided the right of termination upon assignment of the contract. Thus, unlike the facts in *Wegner*, GNMA's right of cancellation derived from the insolvency and bankruptcy of the debtor. As a result, it was necessary for GNMA to establish that the guaranty agreements were executory contracts in the nature of financial accommodations in order to terminate the agreements post-petition.

Notwithstanding the many cases that hold that bonds or other guarantees are executory contracts in the nature of financial accommodations, there are cases that hold that guarantees and bonds are not executory contracts. In *In re Government Securities Corp.*, 111 B.R. 1007 (Bankr. S.D. Fla. 1990), the issuer of a securities

dealer blanket bond sought to have the bond terminated following the takeover of the debtor by the Securities Investor Protection Corp. based on a specific provision to that effect in the bond. The court found that the bond was not an executory contract and held that the automatic termination provision was of no force and effect under §541(c)(1)(B)<sup>6</sup> of the Code.

In *In re Government Securities Corp.*, the court determined that the bond was not executory. Under the "Countryman" approach,<sup>7</sup> since the premiums on the bond had been paid prior to the bankruptcy, there were—in the court's opinion—no remaining obligations on the part of the debtor that, if unperformed, could rise to a claim against the estate. Rather, the only obligations remaining on the part of the debtor were to provide notices of claims. If the debtor failed to properly provide notice of claims, the bonding company would be relieved of its obligations under the fidelity bond. With respect to the "functional" approach, the court reasoned that since rejection of the bond could only benefit the bonding company, a finding that the contract was executory would be detrimental to the estate. It is worthwhile to note that the termination provision relied upon by the bonding company was based on the appointment of a receiver for the principal, as opposed to a unilateral right of termination simply upon notice. Presumably, a unilateral right of termination would have been exercisable upon relief from the automatic stay without regard to the status of the bond as an executory contract.

Further, the language of §365(c)(2) that prohibits a trustee from assuming or

<sup>6</sup> Section 541(c)(1)(B) provides, in relevant part, that "an interest of the debtor in property becomes property of the estate...notwithstanding any provision in an agreement...that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement..."

<sup>7</sup> The Code does not define an executory contract. The legislative history of §365 states that an executory contract is a contract in which performance remains due on both sides. H.R. Rep. No. 95-598, at 347 (1998), reprinted in 1978 U.S. Code Cong. & Admin. News, 5787, 6303. Some courts and commentators have articulated this view of an executory contract as one in which "the obligations of both the bankrupt and the other party to the contract are 'so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other.'" *In re Government Securities Corp.*, supra 111 B.R. at 1011, citing Countryman, *Executory Contracts in Bankruptcy*, 57 Minn. L. Rev. 439, 460 (1973), cited in *In re Charter Co.*, 52 B.R. 267, 270 (Bankr. M.D. Fla. 1985). Other courts have analyzed contracts under an analysis referred to as the "functional" approach. For example, in *In re G-N Partners*, 48 B.R. 462, 465 (Bankr. D. Minn. 1985), and *In re Arrow Air Inc.*, 60 B.R. 117, 120 (Bankr. S.D. Fla. 1986), both courts ultimately determined that the test for executory contracts based on mutuality of the remaining obligations would be too limiting if literally applied and would not serve to achieve the goals of the Code. Rather, those courts and others have adopted an approach recognizing that the purpose of allowing a debtor-in-possession to assume or reject an executory contract is to enable a debtor to take advantage of a contract that will benefit the estate by assuming it or, alternatively, to relieve the estate of a burdensome contract by rejecting it. Accordingly, under the "functional" approach, even though there may be material obligations outstanding on the part of only one party to the contract, the contract nevertheless may be deemed executory if its assumption or rejection would ultimately benefit the estate.

<sup>5</sup> Section 362(k) (formerly §362(h)) provides that "an individual injured" by a violation of the automatic stay shall recover actual damages and, in appropriate cases, punitive damages. There is a split in circuits whether corporate debtors may recover damages under §362(k). The Third and Fourth Circuits have held that former §362(h) is applicable to business entities. *Cuffee v. Atlantic Business and Community Development Corp.*, 901 F.2d 325, 329 (3d Cir. 1990); *Budget Service Co. v. Better Homes of Va. Inc.*, 804 F.2d 289, 292 (4th Cir. 1986). Other circuits have held that the literal language of the statute is unambiguous and that for business-entity debtors, contempt proceedings are the proper means of compensation and punishment for willful violations of the automatic stay. *Maritime Asbestosis Legal Clinic v. LTV Steel Co.*, 920 F.2d 183 (2d Cir. 1990); *Sosne v. Reinert & Duree P.C.*, 108 F.3d 881, 884 (8th Cir. 1997).

assigning an executory contract that is in the nature of a financial accommodation is without exception. The language is not permissive and does not allow consensual agreements between the debtor and the party providing post-petition financing, such as a surety. In *In re Sun Runner Marine Inc.*, 945 F.2d 1089 (9th Cir. 1991), the Ninth Circuit Court of Appeals held that the express language of §365(c)(2) prohibits a debtor and the party providing the financial accommodation from consensually agreeing to continue the financial accommodation post-petition. In *Sun Runner*, Transamerica provided financing to dealers who purchased boats from Sun Runner. Under the terms of the financing arrangement, if the dealer defaulted, Sun Runner was to repurchase the boat(s) from the dealer and pay the loan balance owed to Transamerica. Sun Runner then filed for bankruptcy. Transamerica and Sun Runner agreed to continue the financial arrangement post-petition and submitted the matter to the bankruptcy court for approval. The bankruptcy court approved the financial arrangement post-petition. Another lender objected, and an appeal followed. On appeal, the court held that since the financial arrangement was a financial accommodation as defined in §365(c)(2), the debtor and Transamerica were prohibited under §365(c)(2) from assuming and continuing the financial accommodation. Rather, the proper procedure to undertake or continue post-petition financing was §364.

The court in *Sun Runner* declined to follow the reasoning in *In re Prime Inc.*, 15 B.R. 216 (Bankr. W.D. Mo. 1981), in which the court held that §365(c)(2) does not prohibit the post-petition assumption of a financial accommodation contract if both the debtor-in-possession (DIP) and the lender wish the contract to be assumed and continued. The court reviewed §365 and various other provisions of the Code permitting a DIP to operate a debtor's business and to incur debt. The *Prime* court concluded that it is apparent that Congress intended businesses under reorganization to proceed in as normal a fashion as possible, noting that the statutory pattern permits the inference in the language of §365(c)(2) that the DIP may assume a contract for debt financing if the creditor consents.

While there may be a divergence among courts regarding the ability of debtors and creditors to continue financial accommodations post-petition, opportunity exists for sureties with bonds that do not contain termination provisions.

Specifically, sureties with bonds that do not contain termination provisions can argue that since §365(c) prohibits a debtor from assuming a financial accommodation, thus the bond as a financial accommodation cannot be assumed by the debtor and accordingly must be terminated. The surety may be able to use this leverage to compel the debtor to allow the bond to be terminated or to issue a replacement bond as new credit under §364 under, perhaps, much more favorable terms allowed under that section.<sup>8</sup>

If a surety intends to pursue a strategy of not continuing the bond as a financial accommodation post-petition, the surety cannot refuse to pay bond claimants or refuse the obligee's demand for performance for claims accrued to the date of the filing of the bankruptcy petition. In practice, in exchange for keeping a bond in effect, a surety will request the debtor provide super-priority lien(s) under §364. Consequently, it is often in the interests of debtors to have bonds determined not to be financial accommodations and/or executory contracts. If a surety is ultimately compelled to seek cancellation of its bond(s) over the objection of the debtor, given the ramifications to the debtor's business and ability to reorganize, such action should be undertaken when consensus is impractical and the surety is otherwise being forced to remain at risk on behalf of a principal that is either not competent or not trustworthy.<sup>9</sup>

In light of conflicts among various bankruptcy courts and circuit courts of appeal, in evaluating its bond in a bankruptcy case, any surety should be aware of how the district or circuit in which the bankruptcy case is filed treats bonds under §§362, 365 and 541. ■

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<sup>8</sup> While a full discussion of §364 is beyond the scope of this article, many practitioners are familiar with the section and its provisions, which enable a debtor to seek court approval for post-petition financing on potentially very favorable terms to post-petition lenders. Those terms can include liens and super-priority liens over other creditors and lien creditors, if no other financing is available.

<sup>9</sup> See *Bond Default Manual* at 350-352 and T. Scott Leo and Gary A. Wilson, "Suretyship and the Bankruptcy Code," in *Law of Suretyship* 9-9 - 9-12 (Edward G. Gallagher ed., 1993).