THE SURETY IN BANKRUPTCY COURT: STRATEGIES FOR CONTROL

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Sureties are often confronted with situations in which their principals, who may be facing default, opt for bankruptcy as a way out of their troubles. The surety can encounter many problems as a result of the bankruptcy filing. Problems facing the surety include: having to address the payment bond claims of subcontractors, suppliers and laborers from bonded projects; these may already be in suit in state court, often in separate actions pending in different jurisdictions. Owners/obligees may be asserting affirmative claims against the principal and surety, demanding that the surety complete the principal's contract, or asserting claims for liquidated or other damages against both the bankrupt principal and surety. The owners/obligees may retain contract funds, refusing to commit them to the completion of the project or the satisfaction of lawful trust fund claims of subcontractors, laborers and suppliers. The surety may not be able to obtain information from the bonded bankrupt principal and the personal indemnitors. Sometimes those indemnitors have filed their own personal bankruptcies. In nearly every case the personal indemnitors invariably dispute the validity or amount of these claims, and the indemnitors (who are often the bankrupt's officers or directors) are refusing to cooperate with the surety unless released from the General Agreement of Indemnity.

In coping with these situations, the surety may want to play an active role in the principal's bankruptcy case. By so doing, it can obtain a degree of control over the proceedings and, depending on the circumstances, may become a key player in shaping the allocation of contract funds and protecting its own rights. The Bankruptcy Court often provides a better forum for the surety to limit or cut off claims of dubious merit and potential bad faith claims from claimants, obligees and even principals. There are also potential down-sides to this approach which should be considered. These are mentioned below.

I. Overview of Bankruptcy Jurisdiction

The 1978 Bankruptcy Code,[1] together with 1984 amendments and other statutes,[2] give Bankruptcy Courts exclusive nationwide jurisdiction over "core" proceedings, *i.e.,* those directly impacting the debtor's estate. Bankruptcy Courts also have the power to address non-core but "related" proceedings which, but for the debtor's petition filing, would be heard elsewhere. What are "core" versus a "non-core, related" proceedings are not fixed concepts. The dichotomy is fertile ground for much litigation; determining the answer often depends on the case law of the circuit in which the court is sitting.[3] In all cases, however, the surety can argue that claims against the performance and payment bonds are sufficiently "related" to its principal's bankruptcy case to have those issues heard and decided in the Bankruptcy Court under 28 U.S.C. §157(b) and (c).[4] A particular Bankruptcy Court may decide that the matter would be better handled elsewhere (such as state court) under principles of abstention, given that most claims against sureties arise under state law and, but for the bankruptcy, would be litigated in state court.[5] As a precaution, then, any and all legally proper bases for federal court jurisdiction (such as diversity) should be asserted to avoid the potential for abstention or remand of the proceedings[6] involving the surety to state court or another non-bankruptcy forum.[7] Abstention-based remands are not appealable.[8]

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[1]11 U.S.C. §101 et seq.

[2]See 28 U.S.C. §157 and 28 U.S.C. §1334(a) and (b).

[3]See, *e.g.*, the cases discussed in footnotes 27 through 29 *infra.*

[4]This is supported by some of the language in *Pacor Inc. v. Higgins*, 743 F. 2d 984 (3rd Cir. 1984). See the discussion *infra.*

[5]See 11 U.S.C. §305 and 28 U.S.C. §1334(c).

[6]See 28 U.S.C. §1452(b). In one unusual instance a Bankruptcy Court abstained from hearing a case even though it had core jurisdiction. *In re Amwest Insurance Group*, 285 B.R. 447 (Bankr. C.D. Calif. 2002).

[7]For example, if true diversity exists but the Bankruptcy Court is hesitant to keep the case, it should withdraw the reference of the matter to the Bankruptcy Court and send the case to the District Court for adjudication. 11 U.S.C. §157(d).

[8]See 11 U.S.C. §305(c).

The surety's fight to keep a claim before the Bankruptcy Court may be a little easier if the claimant seeking abstention has filed a proof of claim against the principal debtor in the main bankruptcy case. By submitting a proof of claim, the claimant agrees to submit to the Bankruptcy Court's jurisdiction.

One key to persuading the Bankruptcy Court to retain jurisdiction is the role the surety intends to play in the case. If the surety steps forward as a problem-solver, with the intent of mitigating damages, paying lawful claims and, where appropriate, suggesting a framework for completion of unfinished projects (especially public works projects), the Court is likely to be more accommodating of the strategies suggested below. If, on the other hand, the surety is seen as obstructionist, essentially using the bankruptcy process as a delaying tactic for its own benefit, a bankruptcy judge may be persuaded to abstain and force the surety to deal piecemeal with performance bond claims, payment bond claims and indemnity actions in state court.[9]

II. Surety Participation in the Bankruptcy Case.

The surety can enter and participate in the bankruptcy proceeding in a number of ways, depending on the situation it is facing.

A. Proof of Claim. By filing a proof of claim, the surety submits itself to Bankruptcy Court jurisdiction. As noted above, this is the case with any other creditor as well, including subcontractors, suppliers, laborers or bonded obligees.

B. Creditors Meeting. The surety can and should attend the Section 341 initial meeting of creditors. While a full examination of the debtor will not be possible at that stage, the surety should at least have the debtor verify the accuracy of the schedules, assets and claims set forth therein as to the bonded projects (the Trustee usually will do this as a matter of course as to the overall petition).

C. Deposition of the Debtor. The surety, together with the Trustee (if any) should

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[9]Though not a surety case, for one example of an obstructionist version of the bankruptcy-concursus strategy which backfired, *see In re Federal-Mogul Global, Inc.*, 300 F.3d 368 (3rd Cir. 2002).

consider conducting a formal Rule 2004[10] deposition of the debtor to examine fully its financial affairs if the surety suspects that the debtor is not being fully candid with it. As part of that process the debtor will be compelled to produce its books and records to support the data in the petition and schedules. The surety should also look for and inquire about suspicious transactions or misuses of contract funds on bonded jobs. Such misuses of funds could render those debts non-dischargeable[11]. Also the surety should look for insider transactions to officers, such as "loan repayments", or fraudulent transfers within the four-year window contemplated by the Code[12] and the Uniform Fraudulent Transfers Acts[13] enacted by many states.

D. Removal. If the surety has been sued in state court by an obligee or bond claimant, it can remove the case to federal district court on the basis of the bankruptcy.[14] The case is then "referred" to the Bankruptcy Court by the District Court for adjudication as a "related" or "core" proceeding in the debtor's case. If there are other bases for federal jurisdiction, such as diversity[15] or a federal question[16], those should be asserted to prevent remand to state court even if the Bankruptcy Court declines to keep the matter as "non-core, related".

E. Adversary Action. If the surety knows it is facing a large number of claims and/or is confronted with a multiple job defaults, another potential strategy for the surety is to

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[10]*See* Fed. R. Bankr. P. 2004, permitting examination under oath of the debtor or anyone else having knowledge of the debtor's financial affairs. This could include corporate officers and others such as accountants.

[11]11 U.S.C. § 523(a)(4) (fraud in a fiduciary capacity).

[12]11 U.S.C. § 548 as to fraudulent transfers, and 11 U.S.C. §550 as to transferees' liability for avoided transfers.

[13]*E.g.*, N.J.S.A. 25:2-20 *et seq*.

[14]See 28 U.S.C. §§ 1334, 1452(a).

[15]See 28 U.S.C. §1332(a).

[16]See 28 U.S.C. §1331.

bring an adversary proceeding - sometimes called a "concursus" or "extension" proceeding - against the debtor, obligees, and all known potential claimants, including subcontractors, laborers, and sources of recovery such as the personal indemnitors, directors, officers, *etc.* as the facts warrant. Previously-filed state court cases should be removed to federal district court for referral to the Bankruptcy Court and consolidation in the concursus proceeding for one unified adjudication. Alternatively, it may be possible to persuade the Bankruptcy Court to enjoin further prosecution of the separately-pending state court actions even if the time for removal of those actions has passed.

The facts the surety could assert as bases for such an action include the surety's payment of claims or undertaking completion of work or financing of the principal. Theoretical legal bases for suit are the equitable concepts of *quia timet* and the *bill of peace*.[17] Under these doctrines, the surety apprehends that some future injury to its interests is imminent, requiring immediate court intervention. These concepts can be used to obtain injunctive relief to stop the uncontrolled flow of contract funds to the debtor's estate, preserve them for the completion of work and payment of lawful claims, and direct their proper application. In extreme instances, where a party is seeking to withhold key materials or information affecting public safety as a means to extort additional payments, the Court will enjoin and direct the party to turn those items over.

The Bankruptcy Court is a court of nationwide jurisdiction,[18] with nationwide service of process available to debtors and other parties in adversary proceedings.[19] It may well be the only

[17]Among the remedies a surety would seek in a bill *quia timet* besides indemnity and subrogation are *exoneration*, where the surety knows it is facing absolute liability, even if it has not yet suffered a loss. See J. Mann & C. Jennings, *Quia Timet: A Remedy for the Fearful Surety*, 20 **Forum** 4 (Summer 1985).

[18]28 U.S.C. § 1334(e).

[19]Fed. R. Bankr. P. 7004(d).

court in which creditors and claimants in multiple jurisdictions can be compelled to appear in a unified proceeding such as the *concursus* adversary complaint.

The *concursus* complaint should name all potential known claimants concerning the projects the surety has bonded (i.e., obligees, subcontractors, laborers). The relief sought should include, among other things, injunctive relief requiring those parties to bring any and all of their claims in one forum - the Bankruptcy Court. The idea is to prevent the spread of multiple proceedings brought by individual claimants in other forums, and the inconsistent results that could result, such as litigation with a claimant in one state and against the personal indemnitors in another, thereby saving expense and damage to the debtor as well as the surety.

If the surety is concerned about potential disputes with other secured or priority creditors such as banks or taxing authorities as to the reach of the surety's rights to control contract funds, they can be joined as parties as well to obtain declaratory relief resolving those issues. To the extent discovery is needed, the Bankruptcy Rules incorporate the federal court rule governing service of process for subpoenas to non-party witnesses.[20]

The *concursus* action should always include the debtor and all individual indemnitors on the surety's general indemnity agreement. As parties to the action, the debtor and the indemnitors will be on full notice of any actions the surety might take and will have an opportunity to assert their positions in the context of a unified proceeding with all other interested parties. They can review, approve, or challenge the claims that have been asserted against the surety as the deem appropriate, and will be bound by the result.

In utilizing these concepts, it is possible either to force claims and cases which otherwise would be adjudicated in one forum to be transferred to the forum where the principal debtor's bankruptcy is pending for a unified adjudication in the interest of judicial economy[21] or to convince the Bankruptcy Court to enjoin prosecution of these actions except to the Bankruptcy Court.

Another important function of the *concursus* proceeding is to compel the debtor, if it has not

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[20]Fed. R. Bankr. P. 9016, incorporating F.R.C.P. 45.

[21]*In re Velocita Corp.*, 285 B.R. 188 (Bankr. N.C. 2002).

already done so, to decide whether to assume or reject the bonded contracts as soon as possible. The debtor should not be allowed to use contract funds for estate administration, then reject the bonded contract after completion and leave the surety to sort out the claims of subcontractors and suppliers itself.

The *concursus* complaint can also contain counts for declaratory relief, without the surety's waiving defenses such as strict compliance with claim notice provisions or limitations periods in the bond or state law (see discussion below). While there is a risk that this might alert claimants who otherwise have not sued to assert their claims, it is not a great risk relative to the advantages.[22] Most subcontractors know who to sue and where their claims must be brought. But the key advantages of the *concursus* proceeding - controlling contract funds and keeping all subcontractor, obligee and indemnity claims in one unified proceeding for uniform adjudication - are far greater.

III. Controlling Contract Funds.

The surety has three key interests in bankruptcy: (1) control the contract fund; (2) ensure the use of the contract fund for the completion of work and the payment of lawful supplier/labor claims, thus reducing the surety's exposure; and (3) avoiding inconsistent results in different forums.

A. Assumption or Rejection.

As a first step, the principal (and the surety) must decided whether to assume the bonded contract with the surety's acquiescence or assistance, or to reject it. The surety's interests should be protected regardless of whether the decision is to assume or reject the bonded contract. If there is to be an assumption, the Code requires that all prior defaults be cured and that adequate assurance be given that the assumed contract can be performed.[23] The continued protection of the performance and payment bond (as written) could be a key component of that adequate assurance.

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[22]For example, where the bond notice provision limits who has standing to bring a claim against the penal sum of the bond or the contract fund. An example would be Little Miller Acts which prohibit sub-subcontractors from making a lien or bond claim if they have not provided requisite notice to the general contractor prior to commencing the work for which the claim is made. *See, e.g.*, N.Y. *State Finance Law* Sec. 137; Mich. C.L.A. 129.207; N.J.S.A. 2A:44-145 (Payment bond claims); N.J.SA. 2A:44-128(b) (municipal mechanics liens). These would still apply to bar claims against the surety.

[23]11 U.S.C. § 365(b).

When there is to be an assumption of the contract, the surety can use the Bankruptcy Court to contain efforts by obligees (especially public bodies) to withhold contract funds on the basis of alleged offsets or claims against the principal. The tactic of these bodies is to force the principal or surety into state court forums which are traditionally friendlier to public bodies and agencies. Once in Bankruptcy Court, however, public bodies in particular often do not know what to do. Bankruptcy Courts, by definition, are more debtor-oriented, and will be less solicitous of weakly-grounded claims for backcharges or liquidated damages– especially where the debtor was performing prior to the bankruptcy.

Bankruptcy Courts tend to be particularly accommodating to sureties seeking to ensure that the contract funds are used to complete unfinished work and/or pay lawful trust fund claimants. The Bankruptcy Court will be much more likely to order that the contract funds be used for the project and defer the adjudication of an obligee's claims to a later time.

An assumption by the debtor of the contract and its subcontracts is also much more likely to control the conduct of subcontractors, laborers and suppliers on the assumed contract. The prospect of ultimate satisfaction of their prior bills (part of the curing of prior defaults), plus the prospect of prompt payment for their further work in conjunction with the assumed contract, should have a calming effect on the proceedings.

Resort to the Bankruptcy Court becomes particularly critical in situations in which a public body's withholding of contract payments for questionable reasons has been a major impetus in the bonded contractor's decision to file for bankruptcy in the first instance. In these situations, public bodies can be enjoined and compelled by the Bankruptcy Court to turn over the funds they are holding for deposit into a trust account controlled by the Court. The surety can then seek a court order directing that the interpleaded funds be utilized to complete and close out the bonded job and, if funds are available after that, to satisfy lawful trust fund laborer/subcontractor claims. This is, in essence, a form of continuing exoneration. Another useful result is that a turnover order directed to a public body often takes away the incentive to litigate over the fund, since the public body cannot use the fund in the meantime as it sees fit, to, say, "allocate" the fund for general purposes or to pay

other creditors. This can promote more prompt, favorable settlements.

B. Trust Fund Theories to Control Contract Funds.

A frequently useful tactic is to have the Bankruptcy Court declare the contract funds to be trust funds. Generally, this relied may be more quickly obtained in the Bankruptcy Court then in other forums – especially if the debtor and creditor's committee join in the motion for this relief. However, The success of this option depends on the state law applicable to the case. In states with strong trust fund statutes like New York[24], the surety's subrogation rights will allow it to assert the rights of the claimants it has paid, since the thrust of the trust fund law is to deem the contract funds to be trust funds for the benefit of those claimants, hence the funds cannot be part of the debtor's estate.[25] Some jurisdictions only apply the trust fund concept to public works projects[26] (in one state, the statutory trust fund law has been deemed to apply only to *private* jobs[27]); others, like Pennsylvania[28], utilize a case-law derived concept impressing trust fund-like restrictions on certain contract funds for the benefit of specified classes of claimants (also described in some contexts as an "equitable lien").[29]

In addition to statutory and case law trust fund protections, the surety's own general indemnity agreement with its principal usually contains an explicit, and enforceable, trust fund right

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[24]See, e.g., New York Lien Law Art. 3-A, §§ 70 et seq. Note that this law does recognize the priority of secured lenders who have properly filed a Notice of Lending.

[25]*In re Alcon Demolition, Inc.*, 204 B.R. 440, 447 (Bankr. D. N.J. 1997), noting that the surety's (and the bond claimants') rights in this context can sometimes be superior to any bank financing or U.C.C. filing; see also *Universal Bonding Ins. Co. v. Gittens & Sprinkle Ent.*,960 F.2d 366 (3rd Cir. 1992). An open question arises when funds from various sources, including bonded projects, have been commingled: does the surety or the financing bank get priority? The answer varies depending on the jurisdiction one is in..

[26]See, e.g., N.J.S.A. § 2A:44-148.

[27]*Earl Dubey & Sons, Inc. v. Macomb Contracting Corp.*, 97 Mich. App. 553, 296 N.W. 2d 582 (1980). *See In re Diversified Transportation Resources, Inc.*, 88 B.R. 635, 641-44 (Bankr. D.N.J. 1988) for a discussion criticizing and limiting opinions such as *Dubey*, and expounding upon the surety's traditional reimbursement, indemnity and subrogation rights.

[28]*See, e.g., Jacobs v. Northeastern Corp.*, 416 Pa. 417, 206 A.2d 49 (1965).

[29]See, *e.g., In re Modular Structures, Inc.*, 27 F.3d 72 (3rd Cir. 1994).

in the proceeds of all bonded projects. Coupled with the long-established concept of "relation back" of the surety's losses to the date of the issuance of the bond,[30] sureties can argue even in "weak" trust fund states that the general indemnity agreement imposes an enforceable trust obligation on bonded contract proceeds which removes them from the debtor's bankruptcy estate for administrative purposes. This argument commands even more force where the surety and the debtor have elected to assume the bonded contract and complete the project.

To the extent trust fund concepts are not deemed to be applicable to a given contract fund, the surety's rights therein might be subordinate to the rights of secured creditors[31] or tax lien creditors[32], among others. Even with these restrictions in mind, however, a surety still can obtain at least some degree of control over the funds, to the extent the law permits it to do so.[33]

IV. Controlling Exposure on the Bonds and Post-Petition Financing

The surety can also use the bankruptcy process to limit post-petition exposure on its bonds and obtain further protections if it is going to assist the debtor post-petition. A number of cases hold that surety bonds are contracts of "financial accommodation" which are not part of the debtor's estate and which therefore cannot be assumed by a debtor in bankruptcy.[34] This legal principle is both a

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[30] *Prairie State Bank v. U.S.*, 164 U.S. 227 (1896); *Hennigsen v. U.S.F.& G. Co.*, 208 U.S. 404 (1908).

[31] In jurisdictions refusing to recognize the trust fund concept in particular cases, secured creditors whose UCC-1 filings predate the principal's default and payments by the surety have obtained superior rights to contract funds despite claims by the surety that its rights under the General Indemnity Agreement and common law (i.e., equitable subrogation) were not governed by the Uniform Commercial Code and in fact related in time back to the date of the time the bond was written. See, *e.g., In re V. Pangori & Sons, Inc.*, 53 B.R. 711 (Bankr. E.D. Mich. 1985); *but see In re Diversified Transportation Resources, Inc., supra*, distinguishing and refusing to follow *Pangori*.

[32] See, e.g., *Capitol Indemnity Corp. v. United States*, 41 F.3d 320 (7th Cir. 1995).

[33] In one recent instance we encountered in a pending case, the trust fund claims and bond claims did not ripen until after the bankruptcy had commenced, but the debtor had continued work. This arguably raised those claims to administrative status under the Code, see 11 U.S.C. Sec. 503(b)(1)(A) and Sec. 507(a), which (if upheld) would prime the interests of secured creditors.

[34] See, *e.g., In re Wegner Farms Co.*, 49 B.R. 440 (Bankr. N.D. Iowa 1985), interpreting 11 U.S.C. §365(c)(2). This principle does not protect sureties from bond claims which ripened pre-petition, of course, but it will prevent the assertion of post-petition ripened claims except in

sword and a shield for sureties, giving it leverage in the event it chooses to participate in a contract assumption. The voluntary continuation of the bond in a contract assumption under conditions acceptable to the surety could constitute new value to the debtor. This is a significant bargaining chip for the surety.[35] For example, sureties generally cannot "cross-collateralize" contract proceeds from different contracts - unless new consideration is given, in which case this item could then be negotiated. On the other hand, in situations where the contract is to be rejected, the "financial accommodation" principle will prevent any contention that the bond obligations continue into the future indefinitely.

The surety's assistance to the debtor in an assumption situation can take several forms. It could tender a completing contractor. The surety could provide limited financial aid to the debtor or advance funds for completion work, with the debtor completing the work.[36] By so doing, it is providing new value to the debtor and thus is entitled to what the Code calls "adequate protection". This concept could include the segregation of all contract funds still being held by obligees into a trust account (controlled by the surety) for exclusive application toward the completion of the bonded project.

Subordination agreements, which are then encompassed in court orders giving the surety's super-priority position with respect to the bonded projects in such situations, are another mechanism for controlling the bond project funds, arbitrating a cross-collateral position and obtaining control.[37] Also, the surety could be given some kind of post-petition super-priority creditor status (giving the surety priority ahead of all classes of creditors except administrative claims as to the bonded

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cases where the surety has voluntarily agreed to step in and has obtained adequate protection for doing so.

[35]Note that a reorganizing debtor may claim a need for further bonding capacity to obtain new work as a bargaining chip as well.

[36] As the discussion of curing past defaults suggests, a real risk for a financing surety is that it could be responsible for other past obligations of the debtor, such as unpaid taxes or labor fund contributions. This potential downside must also be weighed by the surety in choosing its course of action.

[37]11 U.S.C. § 510.

contracts) to the extent it provides funding or commits to do so.[38]

There is another approach which the debtor may suggest but which is of limited value to the surety. The debtor may propose that the surety be given a "replacement lien" in other assets or receivables of the debtor - usually post-petition. The reason debtors like this approach (and sureties should be suspicious of it) is because it realistically only provide protection at the end of the case, assuming the bonded project is completed. The debtor may employ this sanction in order to use contract funds for administrative purposes and "cram-down" the surety's priority. This so-called protection may be worthless if the debtor converts the case to a liquidation.

Of course, each of these approaches must be done formally with court approval, and will probably require some negotiation with secured creditors or other parties who may have provided secured pre-petition financing or be offering additional post-petition financing.

V. Joinder of, and Notice to, Personal Indemnitors.

When a corporate principal files a bankruptcy petition, the personal indemnitors often do not do so themselves. If the surety brings a *concursus* proceeding, without fail it should join the personal (non-debtor) indemnitors as parties in an adversary proceeding in the bankruptcy. This will prevent any future argument that these indemnitors had no notice or lacked an opportunity to contest a particular claim, to raise a particular defense to a given claim, or to object to the surety's settlement or payment of a given claim, or that the surety acted in "bad faith".

An indemnity claim against personal indemnitors may also be a check on the debtor's opting for liquidation, thinking that the surety would thereby be "stuck" with an worthless claim against an asset-free debtor. If the indemnitors are on notice that the surety will pursue them if the debtor fails, they have an added incentive to make it succeed, and this may ensure their fuller cooperation with the surety. Joining the indemnitors also provides a check on the officers and directors using corporate funds to pay themselves unusual salaries or "perks"during the course of the bankruptcy.

Additionally, if there are indications that corporate or contract funds have been misapplied

[38] This is authorized by 11 U.S.C. §§ 364 (c) and (d).

or assets placed out of reach, these issues can be brought to the court's attention.[39] If trust funds have been misapplied, there is an argument that the debt may be non-dischargeable. Again, in connection with making these claims, the surety is advised to assert all possible grounds for federal jurisdiction, such as diversity, in addition to "core" or "non-core, related" bankruptcy jurisdiction.[40]

VI. Some Risks of Surety Participation in the Bankruptcy.

The concursus procedure has some down-sides.

1. By seeking to force all potential claimants to bring their claims in one forum only, the surety risks inviting claims that otherwise might not have been brought against it. These might include other subcontractor/supplier claimants who might not have known of the bond's existence prior to the adversary action.
2. The surety might ultimately be adjudged to have waived some limited defenses, such as contractual or statutory limitations periods and certain right-to-notice protections, by employing this option. These defenses of course are not waived simply because the surety is bringing a declaratory action.
3. In some situations the surety may well elect to avoid direct intervention in the principal's bankruptcy case if it has the choice. One example where a surety might opt for a passive role would be a federal project where the time limitations for bringing Miller Act bond claims were fast approaching; there the surety might well choose to

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[39] It is not clear that the surety can, or should, actually try to litigate these issues itself. Some recent case law suggests only a Trustee can pursue such issues. If this view prevails, the most the surety can do is apprize the court and the Trustee of the existence of these issues, then see if either the court or the Trustee take any action.

[40] Properly framed, an indemnity claim against the debtor in a surety claim situation would be deemed a core proceeding under *Pacor Inc. v. Higgins*, 743 F. 2d 984 (3rd Cir. 1984), which is still good law in most circuits. The showing which must be made is that the indemnity claim will affect the debtor's estate or bind the debtor in some way. Subsequent cases to *Pacor* have noted that not all contracts of indemnity, by themselves, will support an extension of "non-core, related" jurisdiction. *In re Federal Mogul Global, Inc., supra*, 300 F.2d at 376, 379-81. A dispute between non-debtors (like a bond claimant and a surety, or between the surety and a personal indemnitor of the debtor) will create "non-core, related" jurisdiction if the dispute creates a logical possibility that the debtor's estate will be affected by it *(Id.)*. Other bases of federal jurisdiction, such as diversity, should also be asserted if the facts warrant.

simply let the time period run and deal with such claims as may be timely filed.[41] These determinations are of course very fact-sensitive in each case.

4. Under the Code, a surety will not be permitted to assert its payment bond subrogation rights to contract balances unless and until all of the claims in that class on which the surety is a co-debtor have been satisfied in full. In other words, the surety's subrogation rights will be subordinate to that of any unpaid and un-perfected payment bond claimant. The surety can only assert its subrogation rights when all known bond claimants have been paid.[42]

5. The surety must also periodically monitor the entire bankruptcy proceedings to ensure it asserts its rights at key points throughout the case. If the contract is being assumed, the surety must decide whether the bond will follow the assumed contract nevertheless, as an accommodation, in the interest of completing the project and possibly mitigating further damages. Once plan confirmation occurs, the rights and responsibilities of the debtor and claimants are fixed and cannot be changed except through amendment of the plan.

6. The surety must monitor the proposals contained in any reorganization plan.[43] The surety should be mindful of any provision which might impose any kind of cram-down of its rights. The plan may contain post-confirmation injunctions of prosecuting claims against non-debtor officers/indemnitors of the principal; these should be challenged if their existence would interfere with the surety's claims and controls over the indemnitors.

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[41]Though in the meantime, while the surety waits, the pool of contract funds (to which the surety's subrogation rights might otherwise attach) could be paid over to the debtor or authorized by the Court to be spent for other purposes, thus making them unavailable to the surety if the claims are asserted thereafter just before they are time-barred.

[42]11 U.S.C. § 509(c).

[43] An attempt to fashion an arbitration of remaining disputes after plan confirmation was rejected in *In re U.S. Brass Corp.*, 301 F.3d 296 (5th Cir. 2002) where the confirmed plan did not allow arbitration of those disputes as an option.

VII. Conclusion.

The foregoing, of course, is merely a summary of the potential options a surety has in the Bankruptcy Court setting. While there are some risks and downsides, there are real benefits to be had from the surety's active participation in the principal's bankruptcy. The key to early participation by the surety can result in the principal and the Bankruptcy Court recognizing and reaffirming the surety's traditional rights, ideally by consent order and agreement, thereby obviating the need for protracted litigation. The utility of any of these strategies is dependent on the factual scenario and the law of the forum where the case is being heard. Many of the legal principles involved (particularly those involving jurisdictional issues) are extremely complex and subtle, and are by no means settled on a nationwide basis. Even so, given the potential benefits to the surety, these options are well worth careful consideration by any surety confronting its principal's bankruptcy filing.

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