

Dated: June 29, 2009
The following is ORDERED:



Jennie D. Latta

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UNITED STATES BANKRUPTCY JUDGE

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF TENNESSEE
WESTERN DIVISION

In re
LEE'S LANDING COMMERCIAL, LLC,
Debtor.

Case No. 09-21281-L
Chapter 11

**ORDER DECLARING THAT AUTOMATIC STAY DOES NOT APPLY
TO ACTION AGAINST SURETY
(HORIZON CONSTRUCTION GROUP)**

BEFORE THE COURT is the motion of Horizon Construction Group, LLC ("Horizon"), seeking relief from the automatic stay in order to pursue enforcement of mechanics' and materialmen's liens against bonds provided by The Hanover Insurance Company ("Hanover") in suits pending in state court. The Debtor objected to the motion on the basis that termination of the stay would potentially harm the Debtor's reorganization efforts. Hanover, however, did not object. At the hearing scheduled for June 10, 2009, Horizon presented certified copies of related state court pleadings and the Debtor stipulated to the authenticity of the remaining exhibits attached to Horizon's motion. For the following reasons, although the motion filed by Horizon sought relief from the automatic stay, the court has determined that the automatic stay does not apply.

JURISDICTION

The bankruptcy courts have concurrent jurisdiction with non-bankruptcy courts to determine whether pending litigation is subject to the automatic stay. *See, e.g., Chao v. Hospital Staffing Services, Inc.*, 270 F.3d 374, 384 (6th Cir. 2001); *In re Baldwin-United Corp. Litig.*, 765 F.2d 343, 347 (2d Cir. 1985); *In re Mid-City Parking*, 332 B.R. 798, 803-04 (Bankr. N.D. Ill. 2005). This is a core proceeding. 28 U.S.C. § 157(b)(2)(G).

FACTUAL BACKGROUND

The Debtor engaged Horizon to serve as general contractor to make tenant improvements at property leased by the Debtor for two projects known as the King Biscuit Project and the Ground Zero Project. Horizon claims that it fully performed all of its obligations, but the Debtor failed to pay the contract balances owed in the amounts of \$103,616.98 and \$229,551.37, respectively. Horizon recorded notices of lien and commenced two separate suits to enforce its liens in the Chancery Court of Shelby County, Tennessee. Hanover provided release of mechanics' and materialmen's lien bonds, which were recorded in the office of the Shelby County Register. The bonds, which are substantively identical, provide as follows:

KNOW ALL MEN BY THESE PRESENTS: THAT WE, Lee's Landing Garage, LLC, as Principal,¹ and The Hanover Insurance Company, a corporation duly licensed to transact surety business in the State of Tennessee, as Surety, are held and firmly bound unto Horizon Construction Group, LLC, as Obligee, in the sum of [the applicable claim] lawful money of the United States of America for the payment whereof, well and truly to be made, we hereby bind ourselves, our heir executors, administrators, successors and assigns jointly and severally, firmly by these presents.

THE CONDITIONS OF THE OBLIGATION IS SUCH THAT:

WHEREAS, Horizon Construction Group, LLC, is the claimant under that certain Mechanic's Lien in the amount of [the applicable claim], which was recorded on or about [the applicable date], in the official records of the Office of the Register of Deeds, Shelby County, Tennessee as Instrument No. [the applicable number], on a project at [number] Lt. George W. Lee Avenue, Memphis, Shelby County, Tennessee, said property being owned by Lee's Landing Garage, LLC, legally described as follows:

¹ The parties agree that the name "Lee's Landing Garage, LLC" appears here as the result of a scrivener's error, and that the intended principal was the Debtor.

See Exhibit "A"

WHEREAS, the Principal disputes the correctness or validity of such claim of Mechanic's Lien and desires to free all the above-described real property from the effect of such claim of lien.

NOW, THEREFORE, if said Principal shall pay or cause to be paid in full or otherwise discharge the lien claim of Horizon Construction Group, LLC, or satisfy any judgment rendered in favor of Obligee on said lien, then this obligation shall be void; otherwise to remain in full force and effect.

Tr. Ex. 5. Horizon filed amended complaints naming Hanover a party defendant. The separate suits were consolidated, and Horizon commenced discovery before the Debtor filed its Chapter 11 petition on February 5, 2009. The Debtor lists the claims of Horizon as disputed. The Debtor's designated representative, John Elkington, refused to attend the rescheduled Rule 30 deposition of the Debtor and the deposition of himself individually on the basis of the filing of the Debtor's bankruptcy petition.

Horizon asserts that if it is not permitted to pursue its bond claims, Horizon will suffer "extreme economic detriment" and "irreparable injury, loss and damage." Horizon asserts that cause exists to grant it relief from the automatic stay because the filing of the bonds had the effect under state law of discharging the underlying liens. Thus Horizon seeks to recover from the bonds only, and not from the Debtor. Horizon asserts that the bonds are not property of the bankruptcy estate and are not necessary to the Debtor's reorganization. Horizon requests that the provisions of Fed. R. Bankr. P. 4001(a)(3) be waived and that any order entered in its favor be enforceable upon entry.

The Debtor initially responded that continuation of the litigation would impede its reorganization efforts both because of the time needed to defend its position in the state litigation and because of the resulting indemnity claim that inevitably will be filed by Hanover in the event that Horizon is successful in establishing its right to judgment. As the result of the court's prior decision finding the Debtor to be administratively insolvent and granting relief from the automatic stay to Lee's Landing Garage, LLC (Doc. No. 85), the Debtor concedes that there is now no reorganization in prospect. The Debtor relies solely upon the automatic stay and has not sought extraordinary injunctive relief.

DISCUSSION

Upon the filing of the Debtor's bankruptcy petition, an estate was created comprised of all the legal and equitable interests of the Debtor in property wherever located and by whomever held. 11 U.S.C. § 541(a)(1). In addition, the filing of the petition operated as a stay against the continuation of judicial actions against the Debtor and against property of the estate. 11 U.S.C. § 362(a)(1). Horizon argues that the effect of obtaining the bonds was to release the property of the Debtor from its claims or potential claims and transfer them to the bonds. Further, Horizon argues that the bonds are not property of the estate. Thus, Horizon urges that the automatic stay does not apply to the pending actions in Chancery Court. In the alternative, Horizon asks the court to grant relief from the automatic stay for cause. While the Debtor did not fully develop its response, it did list the bonds among its assets on Schedule B filed in this case. Doc. No. 16. An initial question is thus whether surety bonds, acquired by a debtor to release its property from pending liens, are property of the bankruptcy estate protected by the automatic stay.

Applicable Law

Whether an interest of a debtor is property of the bankruptcy estate is a question of federal bankruptcy law, but the bankruptcy courts are instructed to look in the first instance to state law to determine whether the debtor has a legal or equitable interest in property as of the commencement of the case. *Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914 (1979). As the Court has explained:

Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law. Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both State and federal courts within a state serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving a "windfall merely by reason of the happenstance of bankruptcy." The justifications for application of state law are not limited to ownership interests.

Id., 440 U.S. at 54-55, 99 S. Ct. at 918 (citations omitted). Because the bonds were given in Tennessee pursuant to a Tennessee statute, the court will look to Tennessee law whenever possible to determine the interest of the Debtor in the bonds. *See Ohio Cas. Ins. Co. v. Travelers Indem. Co.*,

493 S.W.2d 465, 467 (Tenn. 1973)(In the absence of an enforceable choice of law clause, Tennessee courts apply the law of the state with the view to which a contract is made.).

Several cases decided early in the history of the present Bankruptcy Code conclude that a surety bond is not property of the bankruptcy estate. Cases frequently cited include *In re Mansfield Tire & Rubber Co.*, 660 F.2d 1108 (6th Cir. 1981); *In re Buna Painting & Drywall Co.*, 503 F.2d 618 (9th Cir. 1974); *In re McLean Trucking Co.*, 74 B.R. 820, 827 (Bankr. W.D.N.C. 1987); *In re Apache Constr., Inc.*, 34 B.R. 415 (Bankr. D. Ore. 1983); *In re Jay Forni, Inc.*, 33 B.R. 538 (Bankr. N.D. Cal. 1983). These decisions will be discussed more fully below. None the them presents precisely the issue pending before the court.

Cases relied upon by Horizon

Horizon relies on two decisions decided under the Bankruptcy Act, the predecessor to the Bankruptcy Code of 1978: *In re Patten Paper Co.*, 86 F.2d 761 (1936) and *In re Stanndco Developers, Inc.*, 534 F.2d 1050 (2d Cir. 1976). Horizon also relies upon *O'Malley Lumber Co. v. Lockard (In re Lockard)*, 884 F. 2d 1171 (9th Cir. 1989), decided under the Bankruptcy Code. The court will discuss each of these decisions in turn.

Horizon cites *Patten Paper* merely for the proposition that a creditor should be permitted to enforce its liens against property that does not belong to the debtor. Horizon takes pains to distinguish the Debtor's leasehold interest in real property, which was the subject of Horizon's original mechanics' liens, and its interest in the bonds, which, upon registration, freed the Debtor's real property from the claims of Horizon. Horizon is correct that under applicable state law, the registration of the bonds discharged the underlying liens. *See* Tenn. Code. Ann. § 66-11-142, which provides in pertinent part:

If a lien, other than a lien granted in a written contract, is fixed or is attempted to be fixed by a recorded instrument under this chapter, any person may record a bond to indemnify against the lien. The bond shall be recorded with the register of deeds of the county in which the lien was recorded. The bond shall be for the amount of the lien claimed and with sufficient corporate surety authorized and admitted to do business in the state and licensed by the state to execute bonds as surety, and the bond shall be conditioned upon the obligor or obligors on the bond satisfying any judgment that may be rendered in favor of the person asserting the lien. The bond

shall state the book and page or other reference and the office where the lien is of record. *The recording by the register of a bond to indemnify against a lien shall operate as a discharge of the lien.* After recording the bond, the register shall return the original bond to the person providing the bond. The register shall index the recording of the bond to indemnify against the lien in the same manner as a release of lien. The person asserting the lien may make the obligors on the bond parties to any action to enforce the claim, and any judgment recovered may be against all or any of the obligors on the bond.

Tenn. Code Ann. § 66-11-142(a) (emphasis added). This, unfortunately, does not resolve the question before the court, which is, whether the Debtor has a legal or equitable interest in the bonds themselves, and not in the underlying leasehold interest, which is property of the estate.

Stannco Developers more closely presents the question before this court, but was decided under prior law. There a creditor brought suit in state court to foreclose its mechanics' lien, naming both the debtor and its surety as defendants, a condition to recovery under a mechanics' lien release bond obtained by the debtor. Upon the filing of the debtor's bankruptcy petition, a trustee was appointed and a stay issued preventing the continuation of the suit.² The creditor sought a modification of the stay to permit it to continue its action to final judgment against the surety on its bond, but not against the debtor or the trustee. The district court denied the motion, but the court of appeals reversed. Under prior law, the bankruptcy court was permitted in Chapter X proceedings to “enjoin or stay until final decree the commencement or continuation of a suit against the debtor or its trustee or any act or proceeding to enforce a lien upon the property of the debtor.” *Id.*, 534 F.2d at 1052, quoting Section 116(4) of the Bankruptcy Act, 11 U.S.C. § 516(4) (repealed 1978). The court was without authority, however, to restrain state court proceedings concerning property which was not that of the debtor. The court assumed, without specifically deciding, that the bond was not property of the debtor, perhaps because it focused on the undertaking of the surety rather than the surety's contract with the debtor. Prior law expressly provided that: “(t)he liability of a person who is a co-debtor with, or a guarantor [or] in any manner a surety for, a bankrupt shall not

² The stay was issued pursuant to section 116(4) of the Bankruptcy Act. The Bankruptcy Act also provided for an “automatic stay,” of identical scope to that of the section 116(4) stay, but the automatic stay was only effective upon the entry of an order approving the petition. *See Stannco Developers*, 534 F.2d at 1052, n. 3.

be altered by the discharge of such bankrupt.” *Id.*, 534 F.2d at 1054, quoting Section 16 of the Bankruptcy Act, former 11 U.S.C. § 34.³ The focus of the court’s decision was upon the *jurisdiction* of the bankruptcy court in Chapter X reorganization proceedings, which extended only to “the debtor and its property, wherever located.” *Id.*, 534 F.2d at 1052, quoting Section 111 of the Bankruptcy Act, former 11 U.S.C. § 516(4). The Supreme Court made this point clear: “Congress did not give the bankruptcy court exclusive jurisdiction over all controversies that in some way affect the debtor’s estate.” *Callaway v. Benton*, 336 U.S. 132, 142, 69 S. Ct. 435, 441 (1949). The *Stannco Developers* decision did rest upon an exercise of discretion, but upon the district court’s lack of jurisdiction to restrain the state court action, which the court determined did not implicate property of the debtor.

Under the Bankruptcy Reform Act of 1978, the jurisdiction of the bankruptcy courts was extended to “all civil proceedings arising under [the Bankruptcy Code] or arising in or related to [bankruptcy] cases.” *See* Pub. L. No. 95-598, § 241(a), 92 Stat. at 2668 (enacting 28 U.S.C. § 1471(a)-(b) (1982)(repealed 1984). Following the Supreme Court’s decision in *Marathon Pipeline*,⁴ this jurisdictional grant was adjusted to provide “core” jurisdiction over civil proceedings arising under the Bankruptcy Code or arising in a bankruptcy case, and “non-core” jurisdiction over cases “related to” a bankruptcy case. This broadening of jurisdiction from that provided under the Bankruptcy Act paved the way for the Supreme Court’s decision in *Celotex Corp. v. Edwards*, 514 U.S. 300 (1995), which held that the bankruptcy court’s “related to” jurisdiction includes suits between third parties that have some effect upon the bankruptcy case. 514 U.S. at 309, 115 S. Ct. at 1499. Specifically, the Court held that a bankruptcy court has authority to enjoin judgment

³ Section 34 is the predecessor to current section 524(e) of the Bankruptcy Code, which provides: “Except as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.” 11 U.S.C. § 524(e). This section, while instructive, is addressed to the effect of discharge, but does not itself limit the scope of the automatic stay.

⁴ *Northern Pipeline Constr. Co. v. Marathon Pipeline Co.*, 458 U.S. 50, 102 S. Ct. 2858 (1982) (striking down the Bankruptcy Reform Act’s jurisdictional provisions as unconstitutional).

creditors from satisfying their judgment against a supersedeas bond obtained by the debtor when allowing the judgment creditors to proceed would have had a “direct and substantial effect upon the debtor’s reorganization effort.” 514 U.S. at 310, 115 S. Ct. at 1500. At issue in *Celotex* was an injunction issued by the bankruptcy court pursuant to the broad powers granted to it by section 105 of the Bankruptcy Code.⁵ The fact that the court relied upon section 105 promotes the inference that the automatic stay was not adequate to prevent the action of the judgment creditors and thus, perhaps, that the debtor had no interest in the supersedeas bond that became property of its bankruptcy estate. The Court did not reach those issues. Nevertheless, the Court made clear that the *jurisdiction* of the bankruptcy courts is now broad enough to reach third-party disputes so long as they affect or impede a debtor’s reorganization effort.

The third case relied upon by *Horizon*, *Lockard*, was decided under the Bankruptcy Code. There the issue on appeal was whether the bankruptcy court had jurisdiction to decide a claim against a contractor’s license bond provided by a third-party surety and collateralized by property of the debtor. 884 F.2d at 1173. The bankruptcy court held that the creditor was collaterally estopped from relitigating the decision of the state court that the surety bond was “property of the estate” and that the creditor’s action was subject to the automatic stay. Because the decision of the state court took the form of an unsigned minute entry that was tentative and unreviewable, the court of appeals reversed, and, undertaking a consideration of the underlying substantive issue, concluded that the debtor had no interest in the contractor’s bond that became property of his bankruptcy estate. 884 F.2d at 1178. In doing so, the court distinguished cases in which the debtor-contractor makes a cash deposit to discharge its financial obligation for maintaining a contractor’s license from those in which the debtor obtains a surety bond to discharge the same obligation. The distinction is that of whose property is at risk. The court rejected the argument that the bonds should be treated as property of the estate because allowing access to the bonds would at least indirectly impact the

⁵ 11 U.S.C. § 105(a) provides in pertinent part: “The court may enter any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”

debtor's property pledged as collateral to secure the bonds. Significantly, although the court was unable to rely upon decisions of the applicable state court (Arizona) to determine the debtor's interest in the bonds because there were no reported decisions, the court acknowledged that any inquiry into a debtors' interest in property must begin with *state* law. 884 F.2d at 1177, n. 11 citing *In re McLean Trucking Co.*, 74 B.R. 820, 826-28 (W.D.N.C. 1987), which in turn relied upon *Butner v. United States*, 440 U.S. 48, 55, 99 S. Ct. 914, 918 (1979).⁶

Cases holding that surety bonds are not property of the estate

The court turns now to other cases frequently cited for the proposition that a surety bond is not property of the procuring debtor's estate. The first, *Mansfield Tire & Robber Co.*, 660 F.2d 1108 (6th Cir. 1981), concerned surety bonds pledged as security for the debtor-employer's obligation under state workers' compensation laws. The issue before the court was whether the administration of the state's laws fell within the police and regulatory exception to the automatic stay.⁷ The bankruptcy court held that the determination of claims filed by the debtor's employees for workers' compensation benefits by the Industrial Commission of Ohio did not amount to enforcement of the police or regulatory powers of the state and thus were not excepted from the stay. The bankruptcy court further determined that it would not vacate the stay to permit the claims to proceed, for reasons that are not spelled out in the appellate decision, but must have concerned the debtor's need for protection from claims filed by its sureties. The court of appeals reversed, noting without much discussion that claims paid by the Commission might be reimbursed by resort to the surety bonds pledged as security, which were "property of the Commission and not property of the debtor's estate." 660 F.2d at 1113. The focus of the opinion is entirely upon the police and regulatory

⁶ In *Butner* the Court clarified that although the question of whether an interest of the debtor in property is "property of the estate" is a federal question determined under federal law, the bankruptcy courts must look to state law in the first instance to determine whether the debtor has any legal or equitable interest in property as of the commencement of the case. 440 U.S. at 55, 99 S. Ct. at 918.

⁷ 11 U.S.C. § 362(b)(4) provides: "The filing of a [bankruptcy] petition . . . does not operate as a stay . . . of the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power.

exception to the automatic stay, not upon the debtor's interest or lack of interest in the surety bonds. The decision thus provides little guidance in the present controversy.

Bonjour, Gough & Stone v. Pacific Employers Ins. Co. (Matter of Buna Painting & Drywall Co., Inc.), 503 F.2d 618 (9th Cir. 1974), was decided under the Bankruptcy Act. There the trustee in bankruptcy attempted to require a surety to pay into the bankruptcy estate the penal sums on the debtor-contractor's licensing bonds. The appeal was from an order of the district court denying joint petitions for review of orders of the referee in bankruptcy. Although the decision of the bankruptcy referee is not specifically given, the fact that the trustee is the appellant indicates that the decision was not in its favor. The court of appeals affirmed in a per curiam decision, which adopted the reasoning of *Betzer v. Olney*, 14 Cal. App.2d 53, 57 P.2d 1376 (1936), to the effect that a bankruptcy trustee may not compel payment of penal sums to him because the bonds are not property of the estate. The contractor's bonds, it said, were essentially third-party beneficiary contracts, with the penal sum protecting specified classes of persons harmed in specified ways in dealing with the contractor. Because the debtor-contractor never is entitled to the penal sum, he has no property interest in the bonds; a bankruptcy trustee is not authorized to distribute other persons' property among the debtors' creditors. 503 F.2d at 619 (citations omitted).

McLean Trucking Co. v. Dept. of Ind. Relations (In re McLean Trucking), 74 B.R. 820 (Bankr. W.D. N.C. 1987), involved an attempt by the debtor to restrain any further action to collect on a surety bond posted to satisfy the debtor's obligations as self-insurer of workers' compensation claims. The case is thus factually similar to *Mansfield Tire & Rubber*, but was decided under California law. An audit of the debtor's claims records showed a deficiency in the security posted by it. Under California law, the Self-Insurers Fund was ordered to take over the debtor's obligations. It paid claims and submitted reimbursement requests to its surety. The Self-Insurers Fund called upon the Department of Industrial Relations to collect from the surety the full remaining amount available under the bond and to pay it over to the Self-Insurers Fund. The debtor filed an adversary proceeding asking for a preliminary injunction to prevent any action to collect the

proceeds of the bond because of its potential liability for indemnification, which was supported by a letter of credit secured by certain of the debtor's assets. The debtor sought a declaration that the Department of Industrial Relations was without authority to demand the entire amount of the bond in one lump sum. The debtor asserted that in that event, it would be injured as a result of claims against the so-called Collateral Fund created from the proceeds of the letter of credit. The debtor argued that any action against the surety bond was in effect an action against the debtor, which was stayed by the automatic stay, and further that the surety bond and the Collateral Fund were property of the estate. The debtor further argued that if the proposed actions against the surety bond were not already stayed, the court should exercise its powers under section 105 of the Bankruptcy Code to prevent the diminution of the Collateral Fund. The Self-Insurers Fund and the Department of Industrial Relations countered that the surety bond was not property of the estate ; that an action against the bond was not an action against the debtor; and further, that their actions were exempt from the automatic stay as an exercise of the police and regulatory power.

The debtor in *McLean Trucking* relied heavily upon the decision of the Fourth Circuit Court of Appeals in *In re A.H. Robins Co., Inc.*, 788 F.2d 994 (4th Cir. 1986), which held that the debtor's liability insurance policy, which was the target of numerous claims arising out of its manufacture of the Dalkon Shield, could be considered the "most important asset of the [bankruptcy] estate." 788 F.2d at 1001, quoted at 74 B.R. 824. The issue in *A.H. Robins* was the jurisdiction of the district court to enjoin suits that were filed not against the debtor, but against its insurer and its officers and directors. The court of appeals sustained the district court's jurisdiction and affirmed the propriety of the injunction, elaborating four grounds on which a court may enjoin suits against "the bankrupt or its assets and property." 788 F.2d at 1003-04. In doing so, the court of appeals noted that the exceptions to the automatic stay are not jurisdictional limitations. Under the Bankruptcy Code, as opposed to the Bankruptcy Act, the jurisdiction of the bankruptcy courts was broadened to include the power (granted at section 105 of the Bankruptcy Code) to enjoin parties from proceeding in state

court against non-debtors when the state proceeding is related to a bankruptcy case. 788 F.2d at 1003.

The first of the grounds upon which a bankruptcy court may enjoin non-debtor parties is the “unusual exception” exception to the general rule that limits the reach of the automatic stay to the debtor only. The court would extend the protection of the automatic stay to non-debtors “when there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third party defendant will in effect be a judgment or finding against the debtor.” 788 F.2d at 999. The court limited this exception to situations in which the third party is only derivatively liable and entitled to absolute indemnity from the debtor, not to those in which the third party is independently liable with the debtor. *Id.* The second exception noted by the court of appeals was that provided by section 362(a)(3), which prohibits any action to obtain possession of or exercise control over property of the estate. The court said that the insurance policy at issue constituted property of the estate, and thus that litigation against the insurer was stayed by the express language of section 362(a)(3). The third ground for injunction, said the court, was section 105. The court limited application of section 105 to those circumstances in which an injunction is required to “protect the integrity of a bankrupt’s estate and the Bankruptcy Court’s custody thereof and to preserve to that Court the ability to exercise the authority delegated to it by Congress.” 788 F.2d at 1003, quoting from *In re Johns-Mansfield Corp.*, 49 B.R. 219 (S.D. N.Y. 1984). The fourth basis for injunction in the Dalkon Shield cases cited by the court of appeals was the inherent equity powers of the bankruptcy court, which the court cautioned should only be invoked in “clear and convincing circumstances outweighing the potential harm to the party against whom [an injunction] is operative.” 788 F.2d at 1003.

Considering carefully the conclusions reached by the court of appeals in the *A.H. Robins* case, the *McLean Trucking* court first indicated that it did not “read *Robins* as standing for any broad principle that actions against third parties who have resulting indemnity claims against a debtor are always subject to the automatic stay or must always be stayed pursuant to the discretionary powers

of the court.” 74 B.R. at 826. Applying the guidance of *A.H. Robins*, the court noted first that the case before it was a liquidation case, not a reorganization case. The debtor was therefore not engaged in formulating a plan of reorganization and made no showing that allowing the Self-Insurers Fund and Department of Industrial Relations to proceed against the surety bond would jeopardize the ability of officers and directors to administer the case or form a reorganization strategy. Second, the court said that unlike in *A.H. Robins*, the surety bond was not the most important asset of the case. In fact, the Self-Insurers Fund was the only beneficiary of the bond and there were no competing claims to it. Third, the court said that unlike in *A.H. Robins*, the surety bond was not property of the estate. This was so because of applicable state law, which “specifically divest[ed] the self-insured employer of all right, title and interest in and to the security or its proceeds.” 74 B.R. at 827, referencing California Labor Code § 3701(g). Further, California law established “the unconditional right of the Self-Insurers Fund to ‘obtain from the security deposit of an insolvent self-insurer the amount of the self-insurer’s compensation obligations. . . .’” *Id.*, quoting California Labor Code § 3744(b). Based on the clear provisions of the California Labor Code, the court concluded that the debtor’s estate had no legal or equitable interest in the bond. Citing numerous other authorities, including *Mansfield Rubber* and *Buna Painting & Drywall*, the court concluded:

These authorities establish that a bond posted by a surety to secure the obligations of the debtor does not constitute property of the estate, and that a bankruptcy court lacks jurisdiction to enjoin proceedings to collect on the bond. This conclusion is especially appropriate where, as here, the governing state law expressly divests the debtor of any rights or interests in the bond or its proceeds.

74 B.R. at 828.

Each of the cases relied upon by the *McLean Trucking* court, with one exception, was decided under the Bankruptcy Act. The exception was *In re M.J. Sales & Distr. Co., Inc.*, 25 B.R. 608 (Bankr. S.D. N.Y. 1982), which relied upon pre-Code law and in fact turned upon the question whether recourse against collateral posted by the debtor to secure a letter of credit issued in support of a surety bond would be a voidable preference or improper post-petition transfer. The court did

note, however, that at the step in the process at which the surety pays as the result of its obligation under the bond, no property of the debtor is implicated. The surety's payment to the judgment creditor comes from its own funds, not from the debtor's funds. Further, the honoring of a letter of credit involves transfer of the issuing bank's funds, not of the debtor's funds. Transfer of the debtor's property occurs when the debtor gives collateral for the bank's undertaking, not when the bank applies that property to reimbursement of sums paid by it under the letter of credit. While the court did not address the question whether the surety bond itself constitutes property of the estate, it made clear that payment of the penal sum due under a surety bond involves transfer of the surety's property, not the debtor's. By implication, the court decided that the claim against the surety was not a *direct* violation of the automatic stay, for it held that such action was not an *indirect* violation of the stay as the result of the underlying pledge of the debtor's property, even though the letter of credit issuer would have first to obtain relief from the automatic stay before executing on the property pledged by the debtor. 25 B.R. at 615.

The *McLean Trucking* decision is helpful in pointing to the need to look to state law to determine whether a debtor has an interest in a surety bond that may become property of the bankruptcy estate. It seems at odds, however, with the development of the law in holding that a bankruptcy court is *without jurisdiction* to enjoin proceedings to collect on a surety bond.

In re Apache Const., Inc., 34 B.R. 415 (Bankr. Or. 1983), involved two adversary proceedings brought by the debtor-in-possession to determine whether the Oregon State Builders Board violated the automatic stay when it disposed of claims brought by unpaid subcontractors. Pursuant to applicable state law, a determination in favor of the subcontractors by the Builders Board was necessary to their making a claim against the debtor's surety. The bankruptcy court held that because the expired bonds had been obtained by payment of a premium and no funds would be refunded to the debtor in the event that the claims against the bond were insufficient to exhaust it, the bonds were not property of the estate subject to the automatic stay. The court distinguished the case before it from one in which the debtor had a monetary interest in the bond. The court granted

summary judgment for the Builders Board on the basis that its actions represented an exercise of the police or regulatory power and did not diminish the bankruptcy estate.

In *In re Jay Forni, Inc.*, 33 B.R. 538 (Bankr. N.D. Cal. 1983), the bankruptcy court held that an action by a materialman to recover under a contractor's payment bond was more akin to an action against a guarantor or co-debtor, which is not stayed under § 362(a), than like an action to enforce a materialmen's lien, even though a successful action on a bond might indirectly give rise to a claim against the debtor by the guarantor or co-debtor. 33 B.R. at 541. The court held that surety bonds are not property of the estate and that actions against sureties are not stayed. Pursuant to their undertaking, sureties have an independent liability to the material supplier. *Id.*

The same conclusion was reached by the Bankruptcy Court for the District of Oregon in *Fintel v. Oregon (In re Fintel)*, 10 B.R. 50 (D. Or. 1981), in which the State of Oregon filed a motion to set aside a judgment on the basis of mistake. The judgment at issue voided orders of the State Builders Board as taken in violation of the automatic stay. The court granted the motion, finding that it had mistakenly interpreted the orders of the board as an attempt to impose post-petition liability on the debtor. Rather, the orders permitted enforcement against the debtor-contractor's surety. Relying upon *Buna Painting & Drywall*, the court held that "a corporate surety bond which is provided by a debtor to obtain a contractor's license from the State is not property of the estate." 10 B.R. at 51. The court noted that even the co-debtor stay in Chapter 13 does not stay actions against third parties who guarantee debts in the normal course of their business. *Id.*; see 11 U.S.C. § 1301(a)(1). Further, third party liability in general is not affected by the automatic stay (citing 11 U.S.C. § 524(e)), and the automatic stay does not restrain the exercise of police and regulatory powers (citing 11 U.S.C. § 362(b)(4) and (5)). The court's decision ultimately turned on the regulatory exception to the automatic stay. 10 B.R. at 52.

Were these the only decisions concerning sureties and surety bonds, the court's job would be relatively easy, but none of the reported decisions has facts perfectly aligned with those in the present case. Two of those most factually similar, *Apache Constr.* and *Fintel*, ultimately rely on the

police and regulatory powers exception to the automatic stay, which is not at issue in the present case involving mechanics' and materialmen's lien release bonds, not contractor payment bonds. As might be expected, some courts have reached other conclusions regarding whether surety bonds may be regarded as property of a bankruptcy estate. The court turns now to those decisions.

Cases holding that surety bonds are property of the bankruptcy estate

The first of these cases is *In re Wegner Farms Co.*, 49 B.R. 440 (Bankr. D. Iowa 1985). In that case the issue was whether a bonding company's post-petition efforts to cancel the debtor's grain dealer's surety bond violated the automatic stay. The court held that it did, on the basis that the act of cancellation was an act "to obtain possession of property of the estate . . . or exercise control over property of the estate." The court indicated that,

[a]s with the automatic stay provisions [under the Bankruptcy Code], the scope of this section [section 541(a)] is broad ... and includes all kinds of property, including tangible and intangible property, causes of action ... and all other forms of property currently specified in section 70(a) of the Bankruptcy Act. The debtor's interest in property also includes "title" to property, which is an interest, just as are a possessory interest, or a leasehold interest, for example. What constitutes a legal or equitable interest of the debtor in property is broadly construed.

49 B.R. at 443, quoting House Rep. No. 895-595, 9th [sic] Cong. 1st Sess. (1977) 367; Senate Rep No. 95-989, 95th Cong. 2d Sess. (1978) 82, U.S. Code * Admin. News 1978, pp. 5868, 6323; and *In re Lichstrahl*, 750 F.2d 1488 (11th Cir. 1985). The court distinguished *Apache*, *Forni*, *Fintel*, and *Buna Painting & Drywall* on the basis that their holdings were limited to the proposition that a debtor has no interest in the penal sums intended under a surety bond for the benefit of third party claimants. *Id.* Notwithstanding its lack of interest in the penal sum, the court said, the debtor nevertheless had an interest in the bond. The debtor had an interest in the bargained-for coverage provided by the bond. The debtor's contractual rights constituted intangible property, which was included within the coverage of "property of the estate." Thus, any unilateral act to cancel the surety bonds was an attempt to obtain possession over property of the estate, and was stayed by the automatic stay. 49 B.R. at 442.

The second of the cases indicating that a bankruptcy debtor has an interest in a surety bond that becomes property of the bankruptcy estate is *LTV Corp. v. Aetna Casualty and Surety Co. (In re Chateaugay)*, 116 B.R. 887 (Bankr. S.D.N.Y. 1990), in which the debtor brought an adversary proceeding seeking a declaratory judgment that its sureties were liable under workers' compensation bonds. The Pennsylvania Bureau of Workers' Compensation filed cross claims. Among other issues considered by the court was the question whether the bonds were property of the debtor's estate. Aetna, the surety, urged the court to find that the bonds were not property of the estate because, under Pennsylvania law, a principal could not maintain an action against its surety to compel performance. 116 B.R. at 898. Aetna argued that, as a result, the debtor had not legal or equitable interest in the surety bonds, relying upon the cases previously cited: *Mansfield Tire & Rubber*, *Apache Construction*, *Fintel*, and *Buna Painting & Drywall*. *Id.* Persuaded by *Wegner Farms*, the court concluded that the debtor's bargained-for contractual rights were intangible property included within property of the estate. This conclusion further bolstered the court's determination that the disputes raised by the debtor and Aetna were core proceedings subject to final determination by the bankruptcy court. The issues before the court did not, however, involve the application of the automatic stay.

The third case is *In re Christensen*, 167 B.R. 213 (D. Or. 1994), in which the debtor-contractor brought a declaratory judgment action against the Oregon Construction Contractors Board claiming that it had violated the automatic stay when it ordered him to pay a claimant. The bankruptcy court denied the debtor's motion to set aside the order and impose sanctions. On appeal, the district court reversed as to the violation of the stay, but affirmed the denial of sanctions. The bankruptcy court relied upon its earlier decisions *Apache Construction* and *Fintel*, based upon the alternative holdings: (1) the Contractors Board is exempt from the stay, and (2) the surety bond is not property of the estate. 167 B.R. at 215. The district court distinguished the pending case from the prior ones on the basis of its facts. It said, first, that the governmental unit exception to the automatic stay does not apply where the governmental unit is primarily seeking to enforce a pre-

petition obligation of the debtor toward the governmental unit or a third party (the “Pecuniary Interest Test”), or when the governmental unit is merely adjudicating private rights (the” Public Policy Test”). 167 B.R. at 215-16. The particular proceeding before the Oregon Contractors Board ran afoul of both tests. Second, the court said that the proceeding was not exempt from the automatic stay because its ultimate objective was satisfaction of any judgment from the surety bond, distinguishing the case from *Buna Painting & Drywall* and *Lockard*, in which the action was one directly against the surety. 167 B.R. at 216. The proceeding before the Board was one against the debtor, not the surety, and Oregon law required a claimant to proceed first against the principal. Under Oregon law, the surety became liable only if the principal failed to timely pay. The court noted further that, “[r]equiring the debtor to defend himself in an action for damages before the Contractors Board, and awarding damages against him, is contrary to” the objectives of the Bankruptcy Act: giving the debtor a breathing spell and protecting creditors from diminution of the estate. 167 B.R. at 217. It is important to note that the district court did not squarely address the argument that the surety bond was not property of the estate (because no action had been brought against the surety), but rather found that the proceeding against the Contractors Board was the continuation of a proceeding against the debtor.

***Actions to recover from mechanics’ and materialmen’s lien release bonds
are not stayed by the automatic stay***

Turning now to an application of the various cases to the present dispute, it is clear that the court must look first to state law and the written undertaking of the surety to determine whether the Debtor in this case has an interest in the bonds that is protected by the automatic stay. The court has found no Tennessee case that directly addresses the question of the interest of a principal in a surety bond, but agrees with the general proposition that the a debtor, as purchaser of a surety bond, has at least a contract right in the bond. At issue in this case, however, is not the Debtor’s contractual rights, but the penal sum due under the bonds. The court agrees with those cases which have held that a principal, as co-debtor with its surety, has no interest in the penal sum due under a bond.

Further, the particular bonds at issue do not require that judgment be rendered first as to the principal. The court notes that the bonds obtained by the Debtor are not required by applicable state law, as in some of the cases reviewed, but are merely permitted in the event that a person desires to indemnify against a mechanics' or materialmen's lien. *See* Tenn. Code Ann. § 66-11-142(a) (quoted above). Nevertheless, the statute that permits the bonds also dictates their contents: "the bond shall be conditioned upon the obligor or obligors on the bond satisfying any judgment that may be rendered in favor of the person asserting the lien." *Id.* The statute itself does not require that a judgment be rendered first against the principal, as was the case in *Christensen*, but only that judgment be rendered *in favor of the person asserting the lien*. Similarly, the condition of the bonds themselves requires only "that the principal pay or cause to be paid in full or otherwise discharge the lien or satisfy *any judgment rendered in favor of Obligee* on said lien." Tr. Ex. 5 (emphasis added). Both the Tennessee statute and the bonds seem to permit a direct action against the surety. Indeed, the Restatement provides:

(1) Delay by the obligee in taking action against the principal obligor with respect to the underlying obligation, *or failure of the obligee to take such action*, does not discharge the secondary obligor with respect to the secondary obligation except as provided:

- (A) by applicable statute;
- (B) by agreement of the parties;
- (C) by § 43 of this Restatement; or
- (D) in subsection (2) of this section.

(2) If the failure of efforts by the obligee to obtain satisfaction of the underlying obligation is a condition of the secondary obligor's duty pursuant to the secondary obligation, the secondary obligor is discharged to the extent that the obligee's failure to act with reasonable promptness against the obligor is the cause of the obligee's inability to collect from the principal obligor.

Restatement (Third) of Suretyship and Guaranty § 50 (1996) (emphasis added).⁸

⁸ The exception provided at section 43 concerns the running of the applicable statute of limitations, and thus does not apply in this case. Section 43 provides in pertinent part:

Notwithstanding § 50, if the obligee fails to institute action against the secondary obligor on the secondary obligation until after the obligee's action against the principal obligor on the underlying obligation is barred by the running of the statute of limitations as to that action, the secondary obligor's rights and duties with respect to the principal obligor and the obligee are the same as if, on the day that the statute

The question before this court is not the ultimate liability of Hanover on the bonds, but whether Horizon may maintain an action on the bonds against Hanover without violating the automatic stay. As we have seen, neither the applicable statute nor the agreement of the parties as expressed in the bonds requires Horizon to maintain an action or obtain a judgment against the Debtor before proceeding against Hanover. The bonds specifically provide that the obligations of the principal and surety are joint and several. Tr. Ex. 5. Horizon may pursue an action against Hanover without first or at the same time maintaining an action against the Debtor. The concerns raised in *Christensen* are not present in this case.

The automatic stay prevents actions against the debtor, property of the debtor and property of the bankruptcy estate. *See* 11 U.S.C. § 362(a). Because the defendant in the state court action is not the debtor, and the object of the state court action (the penal sum due under the bonds) is not property of the debtor or the bankruptcy estate, the automatic stay does not apply.

It is true that in the event Hanover pays Horizon, it will be able “to step into the shoes” of Horizon as a creditor of the Debtor. In this regard, Tennessee applies the doctrine of equitable subordination. *See Acuity v. McKee Eng’g, Inc.*, slip op. at * 3, 2008 WL 5234743 (Tenn. Ct. App. 2008). Adopting the Restatement, the Tennessee Court of Appeals explained the doctrine of equitable subordination thus:

The principles of equitable subordination have been summarized as follows:

[A] surety or guarantor, by payment of the debt of his principal when he is obligated to make that payment, acquires an immediate right to be subrogated to the extent necessary to obtain reimbursement or contribution to all rights, remedies and securities which were available to the creditor to obtain payment from the person or property of any person who, as to the surety, is primarily liable for the debt.

of limitations expired, the obligee had released the principal obligor from its duties pursuant to the underlying obligation without preserving the secondary obligor’s recourse against the principal obligor.

Restatement (Third) Suretyship and Guaranty § 43 (1996).

Ottenheimer Publ., Inc. v. Regal Publ., Inc., 626 S.W.2d 276, 281 (Tenn. Ct. App. 1981). Thus, the surety is entitled to step into the shoes of the creditor. See *Castelman [Constr. Co. v. Pennington]*, 432 S.W.2d [669] at 674 [(Tenn. 1968)]; *Maryland Cas. Co. v. McConnell*, 257 S.W. 410, 412 (Tenn. 1924); see also RESTATEMENT (THIRD) OF SUR. & GUAR. § 27. By completing a project on behalf of its defaulting principal, a surety ‘confer[s] a benefit on the obligee and, therefore, step[s] into the shoes of the obligee.’ *Nat’s Fire Ins. Co. v. Fortune Contr. Co.*, 320 F.3d 1260, 1270 (11th Cir. 2003).

Acuity v. McGhee Eng’g., slip op. at *3-4, 2008 WL 5234743 (Tenn. Ct. App. 2008).

The mere fact that the surety may be substituted for a creditor upon paying the obligee, however, does not mean that the surety is protected by the automatic stay. Nor, indeed, does it entitle the debtor to prevent the action against the surety, except, perhaps, in unusual circumstances not present in this case, and then only by requesting extraordinary relief. See, e.g., *A.H. Robins Co., Inc.*, 788 F.2d at 999, 1003; *McLean Trucking*, 74 B.R. at 826. Instead, the court is persuaded by those cases that exclude the corporate surety and the surety bond from the reach of the automatic stay where the only interest that is implicated in the state court action is the penal sum due to the obligee as conditioned by the terms of the bond. The court agrees with the decision of the district court in *Fintel* that if the drafters of the Bankruptcy Code intended or believed that the automatic stay protects corporate sureties or prevents actions against them, they would not have made them an exception to the co-debtor stay in Chapters 12 and 13. See 11 U.S.C. §§ 1201(a) and 1301(a).

Notwithstanding the implication that the Debtor may be adversely affected by the outcome of the litigation between Horizon and Hanover, the state court action, being one against bonds issued by Hanover, directly implicates property of Hanover and not of the Debtor. Thus, while the bankruptcy court would have *jurisdiction* to enjoin the action upon request and a proper showing of equitable grounds, this does not mean that the action is stayed by the automatic stay. Rather, a request for a stay would have to have been made by the Debtor pursuant to the court’s authority under section 105 to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” 11 U.S.C. § 105(a). As no such request has been made and no reorganization appears to be in prospect, the court declines to comment on the appropriateness of the exercise of its extraordinary powers in this or similar cases.

CONCLUSIONS

For the foregoing reasons, the court concludes and declares that the action pending between Horizon Construction Group and The Hanover Insurance Company is **NOT STAYED** and may proceed to judgment notwithstanding the filing of the Debtor's bankruptcy petition. Because of this conclusion, the court need not address the other issues raised by Horizon, but notes that if the court had concluded that the automatic stay does apply to the pending action, it would have found that cause had been established to modify the stay to permit the litigation to go forward because, as stated previously, there is no reorganization in prospect. *See United Savings Assoc. v. Timbers of Inwood Forest*, 484 U.S. 365, 376, 108 S. Ct. 626, 633 (1988) (For purposes of evaluating whether property is essential for an effective reorganization, the court must determine that the property is essential to an effective reorganization that is in prospect.).