Bankruptcy and the Surety – *Now What?*

by Shawn B. Rediger

"We received notice that a bankruptcy was filed related to XYZ Project." These words can cause fear and confusion for sureties and other parties involved. Bankruptcy on a construction project affects the rights and obligations of all parties, including sureties. Many of the typical ways in which a surety handles a construction project or indemnity event are influenced by the Bankruptcy Code, and the parties' contractual rights will be affected by bankruptcy law in ways that may not reflect the parties' original intent. Bankruptcy Court is not always a friendly forum for insurers, and immediate action is required to make sure the surety complies with a complicated set of bankruptcy rules while fulfilling its obligations under the surety agreement. Without a good understanding of the bankruptcy process, it can be costly and intimidating for the surety.

While many issues arise because of a bankruptcy filing, one of the most important features is the automatic stay. The automatic stay is triggered the moment a bankruptcy is filed, and it prevents all future collection efforts, legal proceedings and judgment enforcement activities. Creditors are prohibited from 1) commencing or continuing a lawsuit, 2) enforcing a judgment against the debtor, 3) creating, perfecting or enforcing a lien against estate property (although in some situations a mechanic's lien can be perfected post-petition), and 4) collecting, assessing or recovering a claim against debtor that arose before the bankruptcy was filed. Any action taken in violation of the bankruptcy stay can be sanctioned by the Court. If you are unsure if the automatic stay applies, it is safest to obtain relief from stay before taking action. While the stay is not permanent, it continues until the Bankruptcy Court "lifts" the stay after a motion and hearing.

What happens to a partially performed construction contract in bankruptcy? If the surety wishes to complete performance of a bonded obligation of the debtor principal, it likely is necessary for the surety to file a motion for relief from stay or for assumption or rejection of an executory contract. Partially performed construction contracts are considered to be "executory contracts" which means obligations of the parties have not yet been completely performed (i.e., completion of the work by the general contractor and payment by the owner). If a party to a construction contract files bankruptcy, the other parties should not terminate the contract. What if there is a contract provision allowing rescission if the other party becomes insolvent or files for bankruptcy? Generally, these "ipso facto" clauses are unenforceable under the Bankruptcy Code. Also, the contract is not automatically terminated by a default in contract performance before the bankruptcy was filed. Even if it is unlikely the contract will be completed, the safest way to move forward is to seek relief from stay or request the debtor immediately assume or reject the contract. The Bankruptcy Code gives the trustee (in Chapter 7) or debtor (in Chapters 11 or 13) three options for executory contracts: 1) "reject" or cease performing (generally for contracts with unfavorable terms); 2) "assume" contracts (generally for contracts with favorable terms); or 3) assume and assign favorable contracts if the debtor has no use for it after reorganization or if the debtor can derive significant value for the estate. In general, the decision to assume or reject depends on whether or not assuming the contract will result in a net economic gain to the bankruptcy estate (which may benefit general unsecured creditors). If a contract is assumed and then breached, the non-debtor party is entitled to damages which likely are an administrative expense claim that will be paid as a higher priority if funds available. In addition, if the debtor was in default before assuming the construction contract, the debtor must cure all monetary defaults before assuming and provide adequate assurance of future performance under the contract. The Bankruptcy Court must approve the assumption, and the non-bankrupt party may object. If a debtor or trustee rejects a construction contract, the non-breaching party has a general unsecured claim for damages, and the breach is treated as if it occurred before the bankruptcy was filed.

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In some situations, the debtor may "assume and assign" the contract to a third party even if the contract expressly prohibits such an outcome. First, however, the debtor must do everything necessary to perfect the assumption. The Bankruptcy Code does give some protection to non-debtor parties. Specifically, Section 365(c) provides a debtor may not "assume or assign" an executory contract if "applicable law excuses a party, other than the debtor, to such a contract or lease from accepting performance from or rendering performance to an entity other than the debtor" and such party does not consent to assumption or assignment. Thus, whenever applicable law would prevent assignment of a contract without consent, a debtor is required to obtain consent from the non-debtor party.

A bankruptcy filing presents a number of obstacles for a surety. While a surety may be surprised by a bankruptcy filing, typically there are signs of financial trouble. A surety can best protect its position by being aware of its rights and obligations before and after a bankruptcy is filed.

Williams Kastner assists surety in defeating indemnitor's bad faith and CPA counterclaims.

by Paul K. Friedrich

Williams Kastner's Construction Litigation & Surety Practices Team is proud to announce that it recently assisted one its surety clients in defeating what is believed to be the one of the largest extra-contractual claims ever asserted by an indemnitor against a surety in the State of Washington.

In response to the surety's multi-million dollar lawsuit to recover losses and expenses incurred under a Probate bond, the indemnitor asserted causes of action for common law bad faith, violations of Washington's Consumer Protection Act (CPA), breach of contract, and promissory estoppel. The surety's indemnity lawsuit arose from a complex Probate action in Alabama in which the surety suffered losses and expenses in excess of $2,000,000.00 arising out of the surety's payment of a claim over the objection of its principal/indemnitor. Thereafter, the surety filed an action, in King County Superior Court, seeking to its losses and expenses. The indemnitor responded with the above-referenced counterclaims.

Williams Kastner's Surety Team filed a series of motions for partial summary judgment seeking dismissal of the bad faith, CPA, breach of contract, and promissory estoppel claims. Despite fierce opposition, the court granted the motions and dismissed all counterclaims with prejudice. With respect to the bad faith claim, the court held that there is no fiduciary relationship between a principal/indemnitor and a surety and, thus, the indemnitor lacked standing to assert a bad faith claim. Following dismissal of the indemnitor's counterclaims, Williams Kastner obtained a judgment against the indemnitor for the full amount of the surety's losses and expenses. The outcome is notable given what appears to be a growing trend in Washington to assert extra-contractual claims against sureties.

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GROWTH MODE

WILLIAMS KASTNER'S CONSTRUCTION AND SURETY PRACTICE TEAM ADDS TO ITS RANKS

Effective May 2, 2016, Jeff H. Yusen and Alexander Friedrich, founding partners of the Seattle-based surety defense law firm of Yusen & Friedrich, joined the Williams Kastner Construction and Surety Practice Group. Jeff and Alex and, more recently, Paul Friedrich, have represented sureties in the Pacific Northwest for almost 40 years. Now combining with the Williams Kastner team consisting of Construction and Surety Practice Group Chair Todd Blischke, Tom Ped, Meredith Dishaw and Sarah Visbeek, the Group will occupy a unique place in the surety defense market as it is large and experienced enough to handle matters that would overwhelm smaller practices but with a cost-conscious overhead model that will allow the Group to provide representation with significant expertise and "bench-strength" unmatched in this region.

The Group, with over 100 years of collective experience in the surety industry, is excited with the blend of wisdom, experience and synergy that has come with the combination of the two practices and looks forward to working with the surety industry in all of its facets. As always, anyone in the group is available to respond to inquiries and questions from the surety industry.

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