January 1802

# The State of South Carolina

## Office of the Attorney General

T. TRAVIS MEDLOCK
ATTORNEY GENERAL

REMBERT C. DENNIS BUILDING
POST OFFICE BOX 11549
COLUMBIA, S.C. 29211
TELEPHONE 803-758-2072

September 18, 1985

Herman B. Lightsey, Jr., Director
Coverage and Compliance
S.C. Industrial Commission
Middleburg Office Park
1800 St. Julian Place
Columbia, South Carolina 29204

Dear Mr. Lightsey:

You have asked, on behalf of Chairman Reid, whether surety posted by a self insured employer would be considered part of the estate of the employer if the employer filed for bankruptcy. Pursuant to § 42-5-20 of the amended South Carolina Code the Industrial Commission has permitted employers to qualify as self insurers to cover their risk under the Workers' Compensation Act. One of the most significant of the requirements imposed by the Commission upon those seeking approval as self insurers is the posting with the Commission of either a surety bond or security in an approved amount. R.67-3, Rules and Regulations of the Industrial Commission. You express the Commission's concern that if an employer, who is a self insurer under the Act, becomes bankrupt, injured employees (or dependents) may be without recourse in their quest for due compensation. I appreciate your concern and will address herein in separate discussions the issue as it relates to a bankrupt self insurer who has posted a surety bond and the issue as it relates to a bankrupt self insurer who has posted assets as security.

First, I recognize that South Carolina is one of 48 states that permits employers to be self insured under its Compensation Act. While in some states it is sufficient that a self insurer provide evidence of his financial responsibility, South Carolina joins with most states in its requirement that a self insured employer post security or file an approved surety bond to secure payment of workers compensation liability. LARSON Workmen's Compensation Law, § 92.10. The very purpose of these special protective

measures is to forestall the possibility that a claimant might lose his compensation protection due to the employer's bankruptcy. Id., § 92.12. These special protections address a sound policy concern to protect injured employees and in the absence of these special provisions injured employees would be relegated to the same uncertainty as any other creditor in bankruptcy. Id., § 92.12.

The surety bond posted by a self insured employer is on a form approved by the Commission. The bond, although in a penal sum, is essentially for the protection of injured claimants and obligates the surety to pay to the state if the principal fails to perform as required by the South Carolina Workers' Compensation Act, specifically with regard to a default in the payment of compensation benefits. Surety bonds that are provided for the protection of third parties, and not the debtor in bankruptcy, are not considered assets of the bankrupt's estate pursuant to 11 U.S.C. § 541. In the Matter of Cash, 372 F.Supp. 184 (D.Az. 1972); In the Matter of Buna Painting and Drywall, 503 F.2d 618 (9th Cir. 1974). In Cash, the Court found that the debtor had no property interest in a surety bond where the bond was procured to meet a licensing requirement, and the obligation of the bond was to indemnify those injured because of unlawful acts of the licensee. Similarly, in Buna Painting and Drywall, supra, a surety bond required by a licensing statute was held not to be property of the estate. In reaching its conclusion, the Court reasoned that the bond was required essentially for the protection of third parties. The position noted herein appears to be commonly accepted by the Courts.

I advise further that the discharge of the obligation of the bankrupt employer does not effect the liability of the surety. 11 U.S.C. § 524(a); 9A Am.Jur.2d Bankruptcy, § 782; Union Carbide Corp. v. Newboles, 686 F.2d 593 (7th Cir. 1982); In the Matter of General Steel Tank Company, 478 F.2d 294 (4th Cir. 1973). Thus, an action against the surety to enforce its obligation can proceed and judgment rendered thereon despite the commencement of a bankruptcy proceeding by the employer or even the discharge of the employer's debt. Although my review of the terms of the approved surety contract does not reveal any requirement that the debt of the principal (employer) be established by judgment as a condition precedent to enforcement of the obligation of the surety; nonetheless, even if this were a requirement the Courts ordinarily will allow an action to proceed against

the debtor and the surety with the debtor's liability limited. Hill v. Harding, 130 U.S. 699 (1889).

Accordingly, I advise that where the self insured employer has posted an adequate surety bond on the form approved by the Commission, claimants under the Workers' Compensation Act most probably enjoy protection as provided in the surety bond in the event of the bankruptcy of the employer since the surety bond is not an asset of the bankrupt's estate and may be enforced regardless of the bankruptcy of the principal.

A second and distinct question presents where the self insured employer posts property to secure its obligations under the Compensation Act. Importantly, all property of the debtor constitutes the bankrupt's estate and thus, to the extent that the employer maintains any legal or equitable interest in the security posted with the Commission that interest becomes part of the bankrupt's estate. 11 U.S.C. § 541.

Fortunately, however, such a conclusion does not defeat the special interests and concerns of the injured employee since valid liens upon property of the debtor are protected in bankruptcy. 9 Am.Jur.2d, Bankruptcy, § 267. 11 U.S.C. § 101(28) defines a "lien" as

> a charge against or interest in property to secure payment of a debt or secure performance of an obligation.

This definition of a lien has been described as all encompassing. 9A Am.Jur.2d, supra, § 568. The Bankruptcy Act further identifies that there are three exclusive types of liens recognized under the Act: (1) a judicial lien [11 U.S.C., § 101(30)]; (2) a security interest [11 U.S.C., § 101 (43)]; and (3) a statutory lien [11 U.S.C., § 101(45)]. See also, Holt v. Commonwealth of Pennsylvania, 11 B.R. 797 (W.D.Penn. 1981).

The deposit of the security with the Industrial Commission to ensure that the employer meets his obligations under the Compensation Act, constitutes what is commonly known as a "pledge". A "pledge" is a "contract for the delivery of personalty to be retained by the pledgee as security for the performance of some obligation due from pledgor, title remaining in him and possession only passing to the pledgee." 72 C.J.S. Pledges, § 2, at 5. Moreover, a pledge

creates a lien on the property pledged. 72 C.J.S., supra, § 24. This lien upon the property of the debtor would be characterized as the "security interest" as that term is defined at 11 U.S.C.§ 101(43), and thus, by definition it could not also be characterized as a "statutory lien" as that term is used in the Bankruptcy Act. See, Holt v. Commonwealth of Pennsylvania, supra; Appeal of Copeland, 531 F.2d 1195 (3rd Cir. 1976). As well, South Carolina law recognizes that a common law pledge entered pursuant to an agreement creates a security interest in the pledged property. Section 36-9-102(2) of the amended Code.

As earlier mentioned, pursuant to the Bankruptcy Act, valid liens are protected; however, the Act permits the avoidance by the trustee in bankruptcy of those liens that would be voidable by a hypothetical judgment creditor, 11 U.S.C., § 544(a), and thus, an unperfected security interest (pledge) would most likely not be a protected lien in bankruptcy. 9A Am.Jur.2d, supra, § 535; see also, §§ 36-9-301(1)(b) and 36-9-301(3) [South Carolina law provides that an unperfected security interest is subordinate to a subsequent trustee in bankruptcy.] Significantly, the Bankruptcy Act looks to state law to determine whether a security interest is perfected and thus valid as to the trustee in bankruptcy. 9 Am.Jur.2d, supra, § 261; Selby v. Ford Motor Co., 590 F.2d 642 (6th Cir. 1979). In South Carolina the common law is codified relative to pledged property and provides that "[a] security interest in goods, instruments, negotiated documents or chattel paper may be perfected by the secured party's taking possession of the collateral." Section 36-9-305 and COMMENTS; cf. Appeal of Copeland, supra. Thus, most types of personalty may be pledged and the security interest in the personalty perfected by the secured party's taking possession of the collateral. I emphasize that in order for a valid security interest to exist the security interest must attach and thus there must be an underlying agreement creating the security interest. 11 U.S.C., § 101(43); § 36-9-102; Appeal of Copeland, supra.

Accordingly, I advise that property pledged to the Commission to secure obligations of a self insured employer under the Compensation Act most probably becomes an asset of the bankrupt's estate subject, however, to the perfected security interest or lien. I advise further that a

security interest must attach to the property before it may be perfected.

If I can offer further assistance, please call upon me.

Very truly yours,

Edwin E. Evans
Deputy Attorney General

EEE:rmr

REVIEWED AND APPROVED BY:

Robert D. Cook
Executive Assistant for Opinions