

**EIGHTH ANNUAL
NORTHEAST SURETY AND FIDELITY CLAIMS
CONFERENCE
NOVEMBER 6TH - 7TH, 1997**

***THE SURETY'S RIGHTS TO CONTRACT FUNDS IN THE
PRINCIPAL'S CHAPTER 11 BANKRUPTCY PROCEEDINGS***

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Introduction

The surety that provides a bond to its principal is, in reality, providing the surety's credit to the principal in order for the principal to enter into a contract with an obligee. Pursuant to the terms of the contract, the obligee commits to pay the principal a set amount of money, the contract price, to perform the contract. The penal sum of the bond executed by the surety and the principal on behalf of the obligee for a given contract matches the contract price.

In the event of the principal's default under its contract with the obligee and the obligee's termination of the principal's right to perform the work under the contract, the obligee may demand that the surety perform under the performance bond by arranging for the completion of the work and pay under the payment bond by paying the claims of subcontractors and suppliers. The surety that performs the obligations of its principal under the performance bond and/or the payment bond in the event of the principal's default expects that it will receive payment from the obligee of the remaining contract price (the "Contract Funds") as a result of and to the extent of the surety's performance. The receipt of the Contract Funds from the obligee reduces the surety's ultimate loss.

This paper focuses on the substantive rights of the surety competing for the Contract Funds on contracts bonded by the surety for the principal with trustees in bankruptcy (the "Trustee") and with debtors-in-possession (the "Debtor"), and the procedures under the United States Bankruptcy Code (the "Bankruptcy Code")¹ which must be followed in order for the surety to assert and protect its rights to the Contract Funds. Specific emphasis will be placed on the surety's legal and equitable rights to the Contract Funds as cash collateral when the principal files a chapter 11 bankruptcy proceeding.²

I. GENERAL BANKRUPTCY CONSIDERATIONS.

¹ 11 U.S.C. §§ 101-1330.

² It is critical for the surety to substantively and procedurally approach the bankruptcy court in a way that the bankruptcy court is familiar. Surety law is very unfamiliar to most bankruptcy court judges and practitioners. The surety cannot underestimate the difficulty of convincing the bankruptcy court that the surety has substantive rights that need to be protected. Bankruptcy courts, Debtors' counsel and Trustees are generally unaware of the surety's rights.

Another commentator has stated that the surety must educate the bankruptcy court on the principles of suretyship, merge the claims and interests of the surety into the framework established by the Bankruptcy Code, and adapt to the practice in the bankruptcy courts by using its initiative to assert its rights, argue the law and negotiate the best deal possible.

John V. Burch and Wade H. Purcell, *Cash Collateral Litigation and the Surety* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual meeting on August 10, 1993) at 1-2.

A. The Commencement of the Bankruptcy Proceeding.

The principal³ may commence a voluntary case in bankruptcy by the filing of a petition with the bankruptcy court.⁴ The principal then becomes the Debtor. The voluntary case may be filed under either chapter 7 or chapter 11 of the Bankruptcy Code.

Under chapter 7 of the Bankruptcy Code, a Trustee is appointed for the Debtor's estate. The Trustee is charged with certain duties,⁵ including the collection and reduction to money of the property of the Debtor's estate, the investigation of the financial affairs of the Debtor, the examination of the Proofs of Claim of the various creditors, and the closing of the Debtor's estate upon making any distributions of the property of the Debtor's estate to the creditors of the Debtor.

Under chapter 11 of the Bankruptcy Code, the Debtor attempts to reorganize its business in order to continue its operations as a principal/contractor. Unless the bankruptcy court, on request of a party in interest and after a notice and hearing, orders otherwise, the Debtor may continue to operate its business as a "debtor-in-possession."⁶ Ultimately, the Debtor proposes a plan of reorganization,⁷ prepares and disseminates a disclosure statement and solicits acceptances of the plan of reorganization,⁸ and, hopefully, confirms the plan of reorganization at a confirmation hearing.⁹ Assuming that the Debtor complies with its obligations under the plan of reorganization, the Debtor may continue in business as a reorganized debtor.¹⁰

B. The Automatic Stay - Section 362 of the Bankruptcy Code.

³ For the purposes of this paper, the principal is a corporate principal/contractor, not an individual. Therefore, this paper will not discuss the rights of a surety against an individual principal who may file a voluntary case under chapter 13 of the Bankruptcy Code.

⁴ 11 U.S.C. § 301. Under section 303 of the Bankruptcy Code, an involuntary case may be commenced against a principal under either chapter 7 or chapter 11 of the Bankruptcy Code. The requirements, burden of proof, effectiveness and strategic tactics for filing an involuntary case against a principal are beyond the scope of this paper. See T. Scott Leo, *Bankruptcy Considerations, in* BOND DEFAULT II (Duncan L. Clore, 2d ed. 1995) at 257, note 13; Chad L. Schexnayder and Robert J. Berens, *The Surety on Attack in the Principal's Bankruptcy - Proven Strategies and Brave New Tactics* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual meeting on August 11, 1992) at 21-33.

⁵ 11 U.S.C. § 704.

⁶ 11 U.S.C. § 1108. With limited exceptions, a "debtor-in-possession" has the same rights, powers and duties as a trustee. See 11 U.S.C. § 1107. These powers are enumerated in the Bankruptcy Code.

⁷ 11 U.S.C. §§ 1121 - 1124.

⁸ 11 U.S.C. §§ 1125 and 1126.

⁹ 11 U.S.C. §§ 1128 and 1129.

¹⁰ 11 U.S.C. §§ 1141 - 1144.

Section 362 of the Bankruptcy Code provides that the filing of a petition and the commencement of the bankruptcy proceeding operates as a stay, applicable to all entities, including the surety, of many actions.¹¹ Upon the commencement of the Debtor's bankruptcy proceeding, a surety has no right to enforce its claims against the Contract Funds without violating the automatic stay, which remains in effect until the Contract Funds are no longer the property of the Debtor's estate.¹²

A surety may seek relief from the automatic stay in order to enforce its rights against the Contract Funds. After notice and a hearing, the bankruptcy court may provide such relief, such as by terminating, annulling, modifying or conditioning the automatic stay, for the following reasons:

- For cause, including the Debtor's lack of adequate protection of the surety's interest in the Contract Funds;¹³ or
- With respect to a stay of any act against the property of the Debtor's estate, if the Debtor does not have any equity in the Contract Funds, and the Contract Funds are not necessary to an effective reorganization.¹⁴

¹¹ 11 U.S.C. § 362(a) provides that the automatic stay prohibits creditors from taking the following actions against a Debtor or its property:

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

¹² 11 U.S.C. § 362(c). This assumes that the Contract Funds are property of the Debtor's estate. See Section II., infra.

¹³ 11 U.S.C. § 362(d)(1).

¹⁴ 11 U.S.C. § 362(d)(2).

It is the surety's burden of proof on the issues of cause, or whether the Debtor has any equity in the Contract Funds.¹⁵ A party willfully violating the automatic stay may be liable to the Debtor for actual damages, including costs and attorneys' fees, and possibly punitive damages in the appropriate circumstances.¹⁶

C. Property of the Estate - Section 541 of the Bankruptcy Code.

Section 541 of the Bankruptcy Code provides that the commencement of a case under the Bankruptcy Code creates an estate. The Debtor's estate is comprised of certain defined property, wherever it is located and by whomever it is held. Specifically, the property of the Debtor's estate includes all of the Debtor's legal or equitable interests in property as of the commencement of the case.¹⁷ Property of the estate includes proceeds or profits of or from property of the estate.¹⁸ There are certain limitations on what may be property of the Debtor's estate. For example, property in which the Debtor holds only legal title and not an equitable interest becomes property of the estate only to the extent of the Debtor's legal title to such property, but not to the extent of any equitable interest in such property that the Debtor does not hold.¹⁹

II. ARE THE CONTRACT FUNDS PROPERTY OF THE DEBTOR'S ESTATE?

¹⁵ 11 U.S.C. § 362(g)(1).

¹⁶ 11 U.S.C. § 362(h). Section 362(h) of the Bankruptcy Code concerns an "individual injured by any willful violation of a stay." The bankruptcy courts are divided on the issue of whether a creditor violating the automatic stay in effect for a corporate Debtor may be subject to the penalties of section 362(h). For example, under the following cases, a corporate Debtor can recover under section 362(h): In re Atlantic Business & Community Corp., 901 F.2d 325, 329 (3rd Cir. 1990); Budget Service Co. v. Better Homes of Virginia, Inc., 804 F.2d 289, 292 (4th Cir. 1986); In re Mallard Pond Partners, Inc., 113 B.R. 420, 422-423 (Bankr. W.D. Tenn. 1989); In re Tel-A-Communications Consultants, Inc., 50 B.R. 250, 254 (Bankr. D. Conn. 1985). In the following case, the court held that a corporate Debtor cannot recover under section 362(h): In re Chateaugay Corp., 920 F.2d 183, 185-187 (2nd Cir. 1990). The Eighth Circuit and the Ninth Circuit have endorsed this view. There is even a split concerning whether a Trustee is an individual for purposes of recovering under section 362(h). Holding that a Trustee is an individual under section 362(h) is In re Garofalo's Finer Foods, Inc., 186 B.R. 414, 438-439 (N.D. Ill. 1995). Holding that a Trustee represents the estate, but is not a natural person and, therefore, is not an individual under section 362(h) is In re Pace, 67 F.3d 187, 192-193 (9th Cir. 1995).

¹⁷ 11 U.S.C. § 541(a)(1). The question of whether the performance and payment bonds are property of the Debtor's estate is beyond the scope of this paper. However, a number of courts have held that the Debtor has no claim or right to recovery on the performance and payment bonds, and, therefore, has no interest in the bonds that invokes the protection of section 541 of the Bankruptcy Code. In re Buna Painting & Drywall Co., Inc., 503 F.2d 618 (9th Cir. 1974); In re Apache Constr., Inc., 34 B.R. 415 (Bankr. D. Or. 1983); In re Jay Forni, Inc., 33 B.R. 538 (Bankr. N.D. Cal. 1983); In re Fintel, 10 B.R. 50 (Bankr. D. Or. 1981). The bond may be a financial accommodation that may not be assumed by the Debtor under section 365 of the Bankruptcy Code. See Section VII.D. 1., note 149, *infra*. T. Scott Leo and Gary A. Wilson, *Suretyship and the Bankruptcy Code*, in *THE LAW OF SURETYSHIP* 9-1 (Edward G. Gallagher ed., 1993) at 9-6 and 9-7.

¹⁸ 11 U.S.C. § 541(a)(6).

¹⁹ 11 U.S.C. § 541(d).

There is no simple answer to the question of whether the Contract Funds become property of the Debtor's estate under section 541 of the Bankruptcy Code. In determining the nature and extent of the Debtor's interest in property such as the Contract Funds, and whether that property becomes property of the Debtor's estate, the bankruptcy court must look to the property rights of the Debtor as defined by applicable state law.²⁰ The Debtor's rights are determined as of the date of the commencement of the case.²¹ Section 541 of the Bankruptcy Code does not vest the Debtor's estate with any greater rights than those held by the Debtor.²² To the extent that the legal or equitable interests in the Debtor's property included in the estate under section 541(a)(1) of the Bankruptcy Code are limited in the Debtor's hands, they are generally limited to the same extent in the hands of any Trustee because the Trustee acquires only the rights that the Debtor had and nothing more.²³ The Debtor gets no better interest in property after filing the bankruptcy proceeding than the Debtor had prior to filing the bankruptcy proceeding.²⁴

If the Contract Funds are determined not to be property of the Debtor's estate under state law and the Bankruptcy Code, then the surety's rights to the Contract Funds are determined in accordance with applicable non-bankruptcy law. If, however, the Contract Funds are determined to be property of the Debtor's estate, the surety's rights to the Contract Funds and the Trustee's or Debtor's rights to the Contract Funds under either chapter 7 or chapter 11 of the Bankruptcy Code are governed by the provisions of the Bankruptcy Code.

A. Surety Cases Concerning Contract Funds.

²⁰ Barnhill v. Johnson, 503 U.S. 393, 398 (1992); Butner v. United States, 440 U.S. 48, 55 (1979); In re FCX, Inc., 853 F.2d 1149 (4th Cir. 1988), cert. denied, Universal Coops., Inc. v. FCX, Inc., 489 U.S. 1011 (1989).

²¹ In re Julien Co., 44 F.3d 426, 429 (6th Cir. 1995); In re Roberge, 181 B.R. 854, 856 (Bankr. E.D. Va. 1995), rev'd on other grounds, 188 B.R. 366 (E.D. Va. 1995), aff'd, 95 F.3d 42 (4th Cir. 1996); In re Turner, 190 B.R. 836, 840 (Bankr. S.D. Ohio 1996); In re Deblock, 11 B.R. 51, 53 (Bankr. N.D. Ohio 1981).

²² In re Brown, 734 F.2d 119, 124 (2nd Cir. 1984); In re Auto-Train Corp., Inc., 53 B.R. 990, 994 (D.D.C. 1985), rev'd on other grounds, 810 F.2d 270 (D.C. Cir. 1987); In re Psychotherapy and Counseling Center, Inc., 195 B.R. 522, 532 (Bankr. D.D.C. 1996); In re DuBose, 174 B.R. 260, 262 (Bankr. N.D. Ohio 1994); In re Pupura, 170 B.R. 202, 208 (Bankr. E.D.N.Y. 1994); In re Joseph B. Dahlkemper Co., Inc., 165 B.R. 149, 155 (Bankr. W.D. Pa. 1994); In re TTS, Inc., 158 B.R. 583, 585 (D. Del. 1993); In re Coombs, 86 B.R. 314, 317 (Bankr. D. Mass. 1988); In re Lemons & Assocs., 67 B.R. 198, 208 (Bankr. D. Nev. 1986).

²³ Creasy v. Coleman Furniture Corp., 763 F.2d 656, 662 (4th Cir. 1985); In re Alpha Center, Inc., 165 B.R. 881, 883 (Bankr. S.D. Ill. 1994); Integrated Solutions, Inc. v. Service Support Specialties, Inc., 193 B.R. 722, 729 (D.N.J. 1996); In re Royal Business School, Inc., 157 B.R. 932, 941-942 (Bankr. E.D.N.Y. 1993); In re Southwest Citizens' Organ. for Poverty Elimination, 91 B.R. 278 (Bankr. D.N.J. 1988).

²⁴ Universal Bonding Ins. Co. v. Gittens & Sprinkle Enterp., Inc., 960 F.2d 366, 372-73 (3rd Cir. 1992); Old Stone Bank v. Tycon I Bldg. Ltd. Partnership, 946 F.2d 271, 275 (4th Cir. 1991); In re Pupura, 170 B.R. 202, 208 (Bankr. E.D.N.Y. 1994); Aetna Cas. & Sur. Co. v. Game!, 45 B.R. 345, 347 (N.D.N.Y. 1984).

A number of bankruptcy courts have made very different findings concerning whether the Contract Funds are property of the Debtor's estate.²⁵ For example, the cases listed below have come up with the following results:

- In re Universal Builders, Inc.²⁶ [The court found that progress payments were property of the debtor's estate. However, the surety had no interest in the progress payments that required the debtor to provide adequate protection for the surety for the debtor's use of the progress payments. With respect to the retainage, the court ordered that the debtor was enjoined from using the retainage because of the rights of the surety.]

- In re Glover Construction Co., Inc.²⁷ [The court held that progress payments earned by a debtor performing the bonded contracts were property of the estate. However, the court found that the surety had an interest in the progress payments which could be adequately protected. The surety's interest arose by virtue of its equitable rights of subrogation and certain trust fund rights. With respect to the retainage, the court found that Pearlman v. Reliance Insurance Company²⁸ was still good law, especially when the surety's losses exceeded the retainage.]

- In re Alliance Properties, Inc.²⁹ [The contract funds at issue consisted partly of progress payments and partly of retainage, but mostly of funds derived from the settlement of certain contract claims. All became part of the final payment on the contract. The court found that the contract funds were the property of the estate, but subject to the equitable lien rights of the surety and certain trust fund rights.]

- In re Modular Structures, Inc.³⁰ [The court reviewed the provisions of the construction contract between the obligee and the debtor and determined that the debtor was obligated to pay its subcontractors and suppliers before it could receive final payment from the obligee. The surety paid the claims of the subcontractors and suppliers. The court found that the debtor's failure to pay subcontractors and suppliers constituted a breach of its contract just as much as a failure to perform and carry out the terms of the contract would have been a breach. As a result, the contract funds held by the obligee did

²⁵ Eugene R. Preaus and S. Ault Hootsell, III, *Bankruptcy Principal: Defining the Construction Surety's Interest in Contract Balances* (unpublished paper submitted at the Surety Claims Institute annual meeting on June 21, 1990); J. Michael Franks and Michael E. Evans, *A Defense of Established Landmarks: Claims of Construction Sureties to Contract Funds Under Chapter 11*, 25 TORT & INS. L.J. 28 (1989); William F. Haug and Janis M. Haug, *Bankruptcy 1984 v. The Surety's Right to Contract Proceeds*, 20 FORUM 725 (1985).

²⁶ 53 B.R. 183 (Bankr. M.D. Tenn. 1985).

²⁷ 30 B.R. 873 (Bankr. W.D. Ky. 1983).

²⁸ 371 U.S. 132 (1962).

²⁹ 104 B.R. 306 (Bankr. S.D. Cal. 1989).

³⁰ 27 F.3d 72 (3d. Cir. 1994).

not become property of the debtor's estate. The surety was subrogated to the rights of the obligee under the construction contract with the debtor to withhold the retainage as a result of the debtor's failure to pay subcontractors and suppliers (no debt due to the debtor).]

- In re Pacific Marine Dredging and Construction³¹ [The court found that the debtor's failure to pay subcontractors and suppliers was equivalent to the debtor's failure to actually perform the contract. Therefore, the obligee did not owe the contract funds to the debtor. Since the debtor had no legal or equitable interest in the contract funds, the contract funds did not become property of the estate under section 541.]

- In re The Massart Company³² [The surety had received the retainage, but claimed the progress payments. The court found that the progress payments were not property of the debtor's estate under section 541 because the equitable lien of the surety related back to the date of the bond. As a result, the trustee had no property interest under section 541 on the date of the filing of the debtor's bankruptcy proceeding.]

³¹ 79 B.R. 924 (Bankr. D. Or. 1987).

³² 105 B.R. 610 (W.D. Wash. 1989).

B. Summary Observations.

In the author's view, whether the bankruptcy court will determine that the Contract Funds are property of the Debtor's estate is in many ways dependent upon two separate factors:

- Whether the Debtor's bankruptcy proceeding is a case under chapter 11 or chapter 7; and
- Whether the Contract Funds are deemed to be progress payments or retainage.

The cases appear to hold along the following lines:

1. Chapter 11 Debtor/Progress Payments.

If the Debtor has filed a relatively recent chapter 11 bankruptcy proceeding and is "performing"³³ on the bonded contracts, and the Contract Funds appear to be progress payments being paid by the obligee to the Debtor for the performance of the work on the bonded contracts, most bankruptcy courts will hold that the progress payments paid to the chapter 11 Debtor are property of the estate. The extent to which the surety may exercise some control over those progress payments is discussed later in this paper.

2. Chapter 11 Debtor/Retainage.

If the chapter 11 Debtor has failed to pay various subcontractors and suppliers, and the surety has paid those subcontractors and suppliers under the payment bond, the surety should prevail with respect to the retainage on each bonded contract to the extent of the surety's payment bond loss. Pearlman v. Reliance Insurance Company³⁴ remains good law to the extent that the retainage must be used to reimburse the surety.³⁵

3. Chapter 7 - Trustee/Progress Payments and Retainage.

If the chapter 11 bankruptcy proceeding has been converted to a case under chapter 7, or was a chapter 7 bankruptcy proceeding to begin with, any progress payments which may have been due to the Debtor may, in fact, be merely a part of the remaining Contract Funds along with the retainage to the extent of the surety's loss ahead of the claims of the Trustee. Whether the surety has a performance bond loss and/or a payment bond loss, the surety should be entitled to the progress payments and retainage to the extent of the surety's loss ahead of the

³³ In re Glover Construction Co., 30 B.R. 873 (Bankr. W.D. Ky. 1983).

³⁴ 371 U.S. 132 (1962).

³⁵ In re Glover Construction Co., Inc., 30 B.R. 873, 882, n. 28 (Bankr. W.D. Ky. 1983); In re Universal Builders, Inc., 53 B.R. 183 (Bankr. M.D. Tenn. 1985).

claims of the Trustee.³⁶ Once again, Pearlman is good law. While this viewpoint begs the question concerning whether the progress payments and retainage are property of the Debtor's estate under section 541 of the Bankruptcy Code, the surety should ultimately prevail with respect to those Contract Funds.

III. ARE THE CONTRACT FUNDS CONSIDERED "CASH COLLATERAL" AND SUBJECT TO THE RIGHTS OF THE DEBTOR AND THE SURETY?

Section 363 of the Bankruptcy Code concerns the Debtor's use of the property of the estate.³⁷ If the business of the Debtor is authorized to be operated, the Debtor may use property of the estate, other than cash collateral, in the ordinary course of business without notice to the creditors or a hearing and approval by the bankruptcy court.³⁸ However, the Debtor may use property of the estate for purposes other than in the ordinary course of business only upon notice and a hearing and approval by the bankruptcy court.³⁹

"Cash collateral" means cash in which the Debtor's estate and an entity other than the Debtor's estate have an interest.⁴⁰ Assuming that the Contract Funds are deemed property of the Debtor's estate, the Debtor's receipt of the cash constituting the Contract Funds would be property in which the Debtor's estate has an interest. To the extent that the surety, as an entity other than the Debtor, can show it has an interest in the Contract Funds, the Contract Funds would become "cash collateral." If the Contract Funds are "cash collateral" because they represent cash in which the Debtor's estate and the surety have an interest, the Debtor may not use the "cash collateral" represented by the Contract Funds unless:

- Each entity that has an interest in such "cash collateral" consents to the Debtor's use of the Contract Funds;⁴¹ or
- The bankruptcy court, after notice and a hearing, authorizes the Debtor's use of the Contract Funds.⁴²

³⁶ In In re E.R. Fegert, Inc., 88 B.R. 258, 261 (Bankr. 9th Cir. 1988), the court stated:

[W]e doubt that any court would rely on the distinction between progress payments and retainage in a case such as this where the party seeking to assert a superior right, vis-a-vis a surety, is a Chapter 7 trustee concerned solely with liquidation of the estate and not in fulfilling the contractual commitments of the debtor.

³⁷ See also Bankruptcy Rule 4001.

³⁸ 11 U.S.C. § 363(c)(1) and (c)(2).

³⁹ 11 U.S.C. § 363(b)(1).

⁴⁰ 11 U.S.C. § 363(a).

⁴¹ 11 U.S.C. § 363(c)(2)(A).

⁴² 11 U.S.C. § 363(c)(2)(B).

It is the Debtor's duty under section 363(c)(2) of the Bankruptcy Code to forbear from using "cash collateral" such as the Contract Funds⁴³ unless an entity that has an interest in the "cash collateral" (the surety) consents, or the bankruptcy court, upon the Debtor's motion, approves the Debtor's use of the "cash collateral."⁴⁴ Whether the hearing on the Debtor's motion to use "cash collateral" is a preliminary hearing or a final hearing, the hearing is scheduled in accordance with the needs of the Debtor.⁴⁵ However, upon the request of an entity that has an interest in "cash collateral" used or to be used by the Debtor (*i. e.*, the surety with respect to the Contract Funds), the bankruptcy court, with or without a hearing, may prohibit or condition the Debtor's use of the Contract Funds as is necessary to provide adequate protection of the interest

⁴³ Sureties beware! "Do not expect the principal/debtor to police itself on the cash collateral issue. Debtors often use cash collateral until a creditor takes some action to restrict the use. Consequently, cash collateral has a habit of disappearing. Further, the [Bankruptcy] Code does not specify any sanctions against the Debtor for the unauthorized use of cash collateral . . . Do not assume that the Debtor will segregate contract funds. Do not wait for the Debtor to request the [bankruptcy] court's permission to use cash collateral." John V. Burch and Wade H. Purcell, *Cash Collateral Litigation and the Surety* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual meeting on August 10, 1993) at 9. Burch does set forth some ways that the surety may react to the Debtor's unauthorized use of cash collateral. *Id.* at 23-26.

⁴⁴ Prior to obtaining the entity's consent or the bankruptcy court's approval for the Debtor's use of "cash collateral," the Debtor must segregate and account for any "cash collateral" in the Debtor's possession, custody or control. 11 U.S.C. § 363(c)(4).

⁴⁵ 11 U.S.C. § 363(c)(3). Bankruptcy Rule 4001(b) sets forth the procedures for filing the motion and setting the hearing, and describes who should receive notice of the motion and the hearing. Notice should go to all entities that have an interest in the "cash collateral." Frequently, a Debtor's motion to use cash collateral or a secured creditor's motion to prohibit the Debtor's use of cash collateral are combined with a request by the Debtor and the agreement by the secured creditor for post-petition financing for the Debtor under section 364 of the Bankruptcy Code. The bankruptcy court hearing on the various motions concerning the Debtor's use of cash collateral and for the post-petition financing of the Debtor usually occur very early on in the Debtor's bankruptcy proceeding. Since most Debtors' counsel rarely understand that a surety is a creditor of the Debtor and that the surety may have rights in the Contract Funds, the surety may not be aware of the scheduled hearing and may not appear to assert the surety's rights in the Contract Funds. At other times, the surety may well be aware of the hearing and may appear to assert the surety's rights.

If the surety is unaware of the hearing concerning the Debtor's motions to use cash collateral and for post-petition financing, the surety should not lose its rights to the Contract Funds. *In re Alliance Properties, Inc.*, 104 B.R. 306 (Bankr. S.D. Cal. 1989) [The bank negotiated a post-petition cash collateral agreement with the debtor contractor that allowed the debtor to take draws on a pre-petition line of credit to fund its operations while providing the bank with a first priority security interest in all post-petition receivables, including bonded contract receivables. The surety, having never received notice of the motion to use cash collateral and for post-petition financing, nor attending the hearing or receiving the final cash collateral order, was not bound by the cash collateral order. The surety retained its equitable rights of subrogation and equitable lien on the contract funds generated by the pre-petition contracts bonded by the surety. Therefore, despite the fact that the contract funds were property of the estate, the surety prevailed over the bank's post-petition interest.]

If, however, the surety is aware of the hearing, and gets involved in the hearing, the surety must protect its own interest in the Contract Funds. *In the Matter of Hughes-Bechtol, Inc.*, 117 B.R. 890 (Bankr. S.D. Ohio 1990) [The surety fully participated with the bank and the debtor in the negotiation of a cash collateral order by consent (Order Approving Agreement of Debtor in Possession to Incur Secured Debt; To Enter into Post-Petition Finance Agreement; Providing Priority and Liens for Such Financing; Providing Adequate Protection and Use of Cash Collateral) which, by its terms, provided that the bank had rights to all post-petition payments from the bonded contracts until the bank's liens were paid in full. The court held that the surety had waived its rights and/or was estopped from asserting its claims that the bonded contract funds were subject to the surety's equitable rights of subrogation.]

of the other entity (the surety).⁴⁶ At any hearing under section 363 of the Bankruptcy Code, the surety asserting an interest in the “cash collateral” represented by the Contract Funds has the burden of proof on the issue of the validity, priority or extent of the surety’s interest in the Contract Funds.⁴⁷ The Debtor has the burden of proof on the issue of providing adequate protection for the surety asserting an interest in the Contract Funds.⁴⁸

IV. CAN THE SURETY CLAIM AND ESTABLISH AN “INTEREST” IN THE CONTRACT FUNDS FOR THE PURPOSES OF SECTION 363 OF THE BANKRUPTCY CODE?

If the Contract Funds are property of the Debtor’s estate, the surety claiming an interest in the Contract Funds under section 363 of the Bankruptcy Code has the burden of proof concerning the validity, priority or extent of the surety’s interest in the Contract Funds.⁴⁹ Certainly, when the surety underwriters agree to the execution of the bonds, they expect the surety to have an interest in the Contract Funds to the extent that the Contract Funds would be used for the principal’s performance of the contract, including the payment of the bills of the subcontractors and suppliers. The surety underwriters expect “no loss” as a result of the execution of the bonds. To make this expectation effective, the surety must take all efforts to show the bankruptcy court that the surety has an interest in the Contract Funds and to require the Debtor to use the Contract Funds to finish the performance of the work under the contract and pay all bills of the subcontractors and the suppliers for the protection of the surety.

There are a number of “interests” that the surety may claim in the Contract Funds that could be sufficient to allow the surety to file a motion to prohibit the Debtor’s use of the Contract Funds without the surety’s consent or a bankruptcy court order.⁵⁰

⁴⁶ 11 U.S.C. § 363(e). Section 361 of the Bankruptcy Code discusses when adequate protection is required under sections 362, 363 and 364 of the Bankruptcy Code. Section 361 focuses on the financial protection granted to an entity with an interest in the “cash collateral” for the Debtor’s use of that “cash collateral.” The bankruptcy court is allowed to grant other relief to such an entity that results “in the realization by such entity of the indubitable equivalent of such entity’s interest in such property.” 11 U.S.C. § 361(3). What is required to provide adequate protection to the surety for the Debtor’s use of the Contract Funds is described more fully in Section V., infra.

⁴⁷ 11 U.S.C. § 363(o)(2).

⁴⁸ 11 U.S.C. § 363(o)(1).

⁴⁹ 11 U.S.C. § 363(o)(2).

⁵⁰ 11 U.S.C. § 363(e). While section 363(a) of the Bankruptcy Code defines “cash collateral” as cash in which the estate and an entity other than the estate have an “interest,” nowhere does the Bankruptcy Code define the word “interest” as it is used in section 363(a). However, the term “security interest” is defined in section 101(51) of the Bankruptcy Code as a “lien created by an agreement.” In reviewing section 363(a), it is clearly apparent that the word “interest” is more inclusive than a mere “security interest” as the “interest” which the entity other than the estate must have includes certain proceeds, etc. which may be “subject to a security interest.” Section 361 of the Bankruptcy Code concerning adequate protection under section 363 was intended to extend to equitable interests as well as perfected secured interests. H.R. Rep. No. 95-595, 95th Congress, 1st Session 338-40 (1977). Therefore, the “interest” described in section 363(a) may include rights other than rights granted under a security interest, including any rights the surety may obtain utilizing its own

- C. The Surety's Perfected Security Interest in the Contract Funds
 - Under the Uniform Commercial Code.

- If the surety has filed or recorded its agreement of indemnity as a financing statement under the Uniform Commercial Code⁵¹ or has otherwise filed or recorded some other financing statement executed by the principal as a result of a financial arrangement or pursuant to some other agreement, the surety obtains a perfected security interest in the Contract Funds.⁵²

contractual rights and its subrogation rights.

In a long line of cases beginning with Jacobs v. Northeastern Corp., 206 A.2d 49 (Pa. 1965) and National Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843 (1st Cir. 1969), a vast majority of the courts in this country have found that the surety's subrogation rights are not security interests within the meaning of Article 9 of the Uniform Commercial Code, that the surety's subrogation rights exist independently of an Article 9 security interest filing, and that the surety's subrogation rights prevail over the perfected security interest of the secured creditors. Furthermore, a surety that pays post-petition the claims of suppliers and subcontractors is entitled to the Contract Funds ahead of a bank with a perfected security interest in both pre-petition and post-petition receivables of the Debtor. In re Alliance Properties, Inc., 104 B.R. 306 (Bankr. S.D. Cal. 1989). See also In re Pacific Marine Dredging and Constr., 79 B.R. 924 (Bankr. D. Or. 1987).

⁵¹ U.C.C. §§ 9-402 to 9-403 (1987). The surety's filing of its agreement of indemnity as a financing statement under the Uniform Commercial Code is not an election of remedies nor is it a waiver of the surety's subrogation rights. American Oil Company v. L.A. Davidson, Inc., 290 N.W.2d 144 (Mich. App. 1980). The filing of the agreement of indemnity as a financing statement may or may not assist the surety. First, the surety may have more powerful rights under its subrogation rights than under a perfected security interest under the Uniform Commercial Code. Second, the surety's lien may be subordinate and junior to a prior perfected security interest in the principal's assets. John V. Burch and Wade H. Purcell, *Cash Collateral Litigation and the Surety* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual meeting on August 10, 1993) at 13-14. There are numerous other secondary sources discussing the rights of the surety filing its agreement of indemnity as a financing statement and the effectiveness of the surety's actions. Mark Gamell, *Surety Loss, Avoidance & Control Strategies* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual midwinter meeting on January 27, 1995) at 51-58; Armen Shahinian, *The General Agreement of Indemnity*, in *THE LAW OF SURETYSHIP* (Edward G. Gallagher ed., 1993) at 27-17; Douglas M. Reimer, Erik F. Dyhrkopp and Michael Jankowski, *When Sureties Should Perfect Security Interests in Contractor's Assets* (unpublished paper submitted at the Surety Claims Institute annual meeting on June 25, 1992); Chad L. Schexnayder and Robert J. Berens, *The Surety on Attack in the Principal's Bankruptcy - Proven Strategies and Brave New Tactics* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual meeting on August 11, 1992) at 1-11; Richard W. Smith and Victor E. Covalt, III, *Should the Surety Stand on its Equitable Subrogation Rights or File its Indemnity Agreement Under the Uniform Commercial Code*, 69 NEB. L. REV. 664 (1990); T. Scott Leo, *The Financing Surety and the Chapter 11 Principal*, 26 TORT & INS. L.J. 1, 51-58 (1990) and (unpublished paper submitted at the American Bar Association, Forum on the Construction Industry and Tort and Insurance Practice Section, Fidelity and Surety Law Committee joint annual midwinter meeting on January 26, 1989).

⁵² The surety's perfected security interest may be avoided as a preference under section 547 of the Bankruptcy Code. For a more detailed discussion of preferences under the Bankruptcy Code, see Robert J. Berens, *Bankruptcy: Can a Surety be Held Liable for the Prepetition Payments Made by its Principal?* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual meeting on August 10, 1993); J. Michael Franks and John H. Rowland, *Surety Strategy in the Chapter 11 Proceeding: Case Study of a Broke Contractor* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law

The bankruptcy court is very familiar with banks and assignees having a perfected security interest in the accounts receivable of a Debtor, and the “interest” obtained by the bank or assignee under section 363 of the Bankruptcy Code.⁵³

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D. The Surety’s Trust Fund Rights Under the Agreement of Indemnity.

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2. General Issues Involving Trusts Under the Bankruptcy Code.

- • Section 541(d) of the Bankruptcy Code provides as follows:

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• Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor’s legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

•
• Property in which the Debtor holds only legal title and not an equitable interest includes property held in trust by the Debtor.⁵⁴ Whether a trust has been established is a question to be resolved under state law.⁵⁵ If an express trust exists under state law, the Debtor is bound under section 541(d) of the Bankruptcy Code to hold the trust property for the beneficiaries.⁵⁶ If there is a valid trust in existence, “property the debtor held in trust at the time of filing its

Committee annual meeting on August 10, 1993) at 27-36.

⁵³ In re Kuhn Constr. Co., 11 B.R. 746 (Bankr. S.D.W. Va. 1981). [The surety’s Motion to Prohibit the Debtor from Using Cash Collateral was denied because the surety’s agreement of indemnity providing for an assignment of the bonded contract funds was an agreement for a security interest that must be perfected under Article 9 of the Uniform Commercial Code. Because the surety failed to perfect its security interest under its agreement of indemnity, the surety had no interest in the bonded contract funds to be protected under a cash collateral order. The court recognized that the surety did not need to conform to the filing requirements of Article 9 of the U.C.C. to enforce its equitable rights of subrogation, but those rights were not before the court pursuant to the surety’s Motion to Prohibit Use of Cash Collateral.]

⁵⁴ Universal Bonding Insurance Co. v. Gittens & Sprinkle Enterprises, Inc., 960 F.2d 366, 371 (3d Cir. 1992).

⁵⁵ In re B.I. Financial Services Group, Inc., 854 F.2d 351, 354 (9th Cir. 1988); Elliott v. Bumb, 356 F.2d 749, 753 (9th Cir. 1966).

⁵⁶ Georgia Pacific Corp. v. Sigma Service Corp., 712 F.2d 962 (5th Cir. 1983); In re Western Urethanes, Inc., 61 B.R. 243 (Bankr. D. Colo. 1986).

bankruptcy petition is excluded from the bankruptcy estate.”⁵⁷ The trust may be an express trust, a statutory trust or a constructive trust over property held by the Trustee or the Debtor.⁵⁸ Furthermore, Contract Funds subject to a trust that are paid to the Debtor after the filing of its bankruptcy proceeding are held by the Debtor subject to the trust obligations.⁵⁹ The Debtor’s sole permissible administrative act upon receipt of the trust funds is to pay the trust funds to the beneficiaries of the trust.⁶⁰ Notwithstanding the fact that the Trustee or Debtor, as of the date of the filing of the bankruptcy proceeding, obtains certain “strong-arm powers,”⁶¹ those “strong-arm powers” do not prevail over the trust fund rights of the trust beneficiaries under section 541(d) of the Bankruptcy Code.⁶²

⁵⁷ In re B.I. Financial Services Group, Inc., 854 F.2d 351, 354 (9th Cir. 1988) [citing United States v. Whiting Pools, Inc., 462 U.S. 198, 205 n. 10 (1983)].

⁵⁸ Mid-Atlantic Supply, Inc. of Virginia v. Three Rivers Aluminum Co., 790 F.2d 1121 (4th Cir. 1986); In re Glover Construction Co., 30 B.R. 873 (Bankr. W.D. Ky. 1983).

⁵⁹ Universal Bonding Insurance Co. v. Gittens & Sprinkle Enterprises, Inc., 960 F.2d 366, 372-73 (3d Cir. 1992).

⁶⁰ In Mid-Atlantic Supply, Inc. of Virginia v. Three Rivers Aluminum Co., 790 F.2d 1121, 1126 (4th Cir. 1986), the court held that:

[I]f a trust, whether express, statutory, or constructive is established over property in the possession of the trustee or debtor-in-possession, the ‘sole permissible administrative act’ of the trustee or debtor-in-possession is to pay over or endorse over the property to the beneficiary or beneficiaries of the trust.

See also Georgia Pacific Corp. v. Sigma Service Corp., 712 F.2d 962 (5th Cir. 1983).

⁶¹ 11 U.S.C. § 544 (providing the Trustee or the Debtor with the status of a judicial lienholder, a creditor with an unsatisfied execution, and a bona fide purchaser of real property).

⁶² In In re Quality Holstein, 752 F.2d 1009, 1013-14 (5th Cir. 1985), a constructive trust case, the court stated:

As a general rule, it must be held that section 541(d) prevails over the trustee’s strong-arm powers. Although those powers allow a trustee to assert rights that the debtor itself could not claim to property, Congress did not mean to authorize a bankruptcy estate to benefit from property that the debtor did not own. Where state law impresses property that a debtor holds with a constructive trust in favor of another, and the trust attaches prior to the petition date, the trust beneficiary normally may recover its equitable interest in the property through bankruptcy court proceedings.

In In re General Coffee Corp., 828 F.2d 699, 706 (11th Cir. 1987), the court found no difficulty in ruling in favor of the party seeking to enforce its rights under a constructive trust and against the claim of the Trustee. The court stated:

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3. The Trust Fund Nature of the Contract Funds.

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- Many bankruptcy courts have described the trust fund nature of the Contract Funds.

The bankruptcy courts acknowledge that the Contract Funds are encumbered with the rights of others, including the Obligees, unpaid subcontractors and suppliers, and the surety. As such, the Contract Funds are, in essence, trust funds to be held by the Debtor for the protection of others as beneficiaries. The following cases describe the trust fund nature of the Contract Funds.

•

- In re RAM Construction Company, Inc.⁶³ [“RAM could not transfer to Equibank rights in these payments, which are greater than RAM possesses. See Prairie State Bank v. United States, 164 U.S. 227 at 240, 17 S. Ct. 142 at 147, 41 L.Ed. 412 (1896). RAM’s claim to these monies is encumbered first by the owners, then by its unpaid subcontractor, et al., and if unpaid, by its surety. By express contract with the surety and with the owner, RAM is subordinated first to the owner’s claim, second to the subcontractors, et al. and then to the surety. Judge Marsh in Atlantic Refining Co. v. Continental Cas. Co., 183 F. Supp. 478 (W.D. Pa. 1960) recognized the trust nature of these funds until the job is complete and these parties paid. The Supreme Court in Martin v. National Surety Co., 300 U.S. 588, 57 S. Ct. 531, 81 L.Ed. 822 (1937), read into the contract the bond and considered a default under the bond as a default under the contract and imposed an equitable trust upon the funds over the contractor’s assignee.”]

•

- In re Glover Construction Co., Inc.⁶⁴ [The court reviewed two cases “outlining the fundamental reasons for treating contractor monies as a trust fund held for the benefit of materialmen claimants.” Selby v. Ford Motor Co., et al., 590 F.2d 642 (6th Cir. 1979); Parker v. Klochko Equipment Rental Co., Inc., 590 F.2d 649 (6th Cir.), cert.denied, 444 U.S. 831, 100 S. Ct. 60, 62 L.Ed.2d 40 (1979)].

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- In re Pacific Marine Dredging and Construction⁶⁵ [“In an unbroken line of decisions, the courts have held that when a surety executes a bond with a general contractor on a public contract, in favor of the owner, there arises, in the surety’s favor, an equitable right to or lien on funds the owner properly withholds from the contractor. These funds are in the nature of a trust to reimburse the surety who is forced to pay on its bond.”]

•

We believe, however, that for purposes of priority in bankruptcy a constructive trust beneficiary should have the same rights to the trust assets that a beneficiary of an express trust would have. An express trust beneficiary clearly has priority to trust assets over a judicial lienholder or execution creditor.

⁶³ 32 B.R. 758, 760 (Bankr. W.D. Pa. 1983).

⁶⁴ 30 B.R. 873, 878 (Bankr. W.D. Ky. 1983).

⁶⁵ 79 B.R. 924, 928 (Bankr. D. Or. 1987).

• In re Alliance Properties, Inc.⁶⁶ [“The fund is analogous to the corpus of a trust held by the estate for the benefit of the subcontractors and/or the surety.”]

4. The Trust Fund Provision in the Agreement of Indemnity.

• Frequently, an agreement of indemnity contains a trust fund provision.⁶⁷ For example, the trust fund provision may provide as follows:⁶⁸

• Trust Fund. The Principal and the Indemnitors declare and agree that all monies due or to become due under any contract or contracts covered by the Bonds, and all monies received for or on account of any contract or contracts covered by the Bonds, whether in the possession of the Principal or the Indemnitors or otherwise, shall be held in trust as trust funds by the Principal and the Indemnitors for the benefit and payment of all persons to whom the Principal incurs obligations in the performance of any contract or contracts for which the Surety would be liable under any Bond or Bonds. Upon demand by the Surety, the Principal or the Indemnitors shall open a trust account or accounts with a bank designated by the Principal and approved by the Surety for the deposit of the trust funds, and shall deposit therein all trust funds received. Withdrawals from such trust accounts shall be by check signed by the Principal and the Surety.

• If the agreement of indemnity has a trust fund provision that provides that the Debtor holds all Contract Funds in trust in order to pay its subcontractors and suppliers, or to pay the surety in the event that the surety is liable to the subcontractors and suppliers under the payment bonds, the Debtor has a fiduciary duty to the surety to hold the Contract Funds in accordance with the terms of the trust fund provision of the agreement of indemnity.⁶⁹ If a valid express trust is

⁶⁶ 104 B.R. 306, 312 (Bankr. S.D. Cal. 1989).

⁶⁷ See generally, Robert L. Lawrence, Robert M. Wright, George J. Bachrach and William M. Dolan, III, *The Agreement of Indemnity - The Surety's Handling of Contract Bond Problems: Enforcement of the Surety's Rights Against the Principal and the Indemnitors Under the Agreement of Indemnity*, in THE AGREEMENT OF INDEMNITY - PRACTICAL APPLICATIONS BY THE SURETY (George J. Bachrach ed., 1990).

⁶⁸ The following provision of the “agreement of indemnity” has been created by the author. Parts or all of the concepts and/or language may be found in actual agreements of indemnity taken by sureties. The author knows of no present agreement of indemnity that contains the exact language “quoted” in this paper. If, in fact, the language is identical or very similar to the language contained in existing agreements of indemnity used by sureties, the author apologizes. Any similarity is because of happenstance, and not intent.

⁶⁹ The fiduciary relationship created by the trust fund provision of the agreement of indemnity is discussed in In re Jenkins, 110 B.R. 74 (Bankr. M.D. Fla. 1990). In the Jenkins case, the court reviewed a trust fund provision in the surety's General Indemnity Agreement which states as follows:

The Undersigned and their successors, executors and administrators agree

created by the trust fund provision in the agreement of indemnity, those trust rights will be protected under the Bankruptcy Code.⁷⁰

to hold all money or other proceeds of a Contract, however received, as a trust for the benefit of Surety and to use such money or other proceeds for the purpose of performing the Contract and discharging the obligations of the Bond, and for no other purpose until the Bond is completely exonerated.

The court was asked to determine whether the debtor's failure to comply with the trust fund provision as a result of its diversion of certain contract funds constituted a debt which was nondischargeable under the Bankruptcy Code. 11 U.S.C. § 523(a)(4) (which makes a debt nondischargeable as a result of fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny). The issue reviewed by the court was whether the trust fund provision in the agreement of indemnity created a fiduciary relationship. The court stated:

In order for the language of the General Indemnity Agreement to create a fiduciary relationship, i.e. in this case a trust, the language must create a trust, establish a trust corpus, and show an intent by the parties to create a fiduciary relationship . . . this Court finds paragraph 8(T) of the General Indemnity Agreement meets the criteria and a fiduciary relationship was created . . .

⁷⁰10 B.R. at 76.

In re Glover Construction, Inc., 30 B.R. 873 (Bankr. W.D. Ky. 1983). [Trust fund rights may arise in a number of ways, including under an express trust created by the parties to the construction contract, by a statutory trust which arises automatically, or an express trust created under the terms of an indemnity agreement. 30 B.R. at 880, n. 22. "It is a basic tenet of trust law that the trustee has a legal interest in the property he holds, which requires its inclusion under § 541(a). . . ." Under section 541(d), the Bankruptcy Code protects the outstanding beneficial interests, and the property comes into the estate subject to those interests. As a result, "if regarded as in trust, the progress payments are included within the estate, but with important restrictions imposed." 30 B.R. at 881.]

In re Western Urethanes, Inc., 61 B.R. 243 (Bankr. D. Colo. 1986) [While the Colorado trust fund statute created an express trust on contract funds in the hands of the debtor (such that a breach of the statute would bar a discharge under 11 U.S.C. § 523(a)(4)), an exception existed excusing the debtor from holding the contract funds in trust if the debtor furnished performance and/or payment bonds. Therefore, no express trust under the statute would protect the surety. Furthermore, the indemnity agreement between the surety and the debtor would not give rise to a constructive trust. The court stated that there was nothing in the indemnity agreement which "speaks in terms of 'trust'". It does not provide that the Debtor would receive the proceeds in trust as a trustee for the [surety] to be used first for the purposes of paying the claims of suppliers or others who might have claims against the bond. . . .Had the [surety] sought the protection of a trust, it could have been provided for in the [indemnity] agreement." The court stated that the surety could have protected itself by filing its indemnity agreement as a financing statement, but the surety chose not to do so. The indemnity agreement was an "arms length" agreement, the terms of which were dictated by the surety. It did not create a fundamental fiduciary relationship that would impose a constructive trust on the contract funds. 61 B.R. at 246-247.]

In re Construction Alternatives, Inc., 2 F.3d 670 (6th Cir. 1993). [The court held that the trust fund provision of the surety's agreement of indemnity did not have the necessary language to create a valid, express trust under Ohio law because the debtor was not required to keep any portion of the progress payments in a separate trust fund, nor did the debtor actually keep the progress payments in a separate account. Therefore, since there was no trust property held by the debtor, no trust was created. 2 F.3d at 677.] See also Capitol Indemnity Corp. v. Mount Vernon School District, 41 F.3d 320 (7th Cir. 1994); In re Foam Sys. Co., 92 B.R. 406 (Bankr. 9th Cir. 1988).

- - 5. Trusts Under State Law (Maryland).

- - Whether the trust fund provision of the agreement of indemnity provides a surety with an interest in the Contract Funds must be determined under state law.⁷¹ If state law provides that the surety's trust fund provision in the agreement of indemnity creates a valid express trust in the Contract Funds, then the Debtor must hold the Contract Funds in trust for the trust beneficiaries and the surety under section 541(d) of the Bankruptcy Code.

- - For example, under Maryland law, a trust has been defined as the right to the beneficial enjoyment of property, the legal title to which is vested in another.⁷² Generally speaking, the trustee of a valid trust is the holder of legal title to the trust property while the beneficiary takes the equitable estate or beneficial interest.⁷³ It is vitally essential to the existence of any trust that there be a trust res or subject matter and that there be a separation of the legal estate from the beneficial enjoyment.⁷⁴ The trustee is thereby bound to employ the trust for the use and benefit of the beneficiaries, subject to the terms of the trust.⁷⁵

- - An express trust is a fiduciary relationship with respect to property, subjecting the person by whom title is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it.⁷⁶ In Maryland, in order to establish such a binding, enforceable trust, the trust fund provision of the agreement of indemnity must fulfill the following conditions: (1) there must be an expression of an intent to create a trust; (2) there must be a trust property or a res; (3) the trust beneficiaries must be sufficiently defined and ascertainable; and (4) there must be a trustee.

- - The intention to create a trust is apparent from the language of the trust fund provision of the agreement of indemnity described above in this paper. Technical language is not required as long as the intention

⁷¹ See cases cited supra notes 20 and 55. The following analysis reviews the principles involved in trust law in the State of Maryland. What is important is not the Maryland law on trusts, but the kind of analysis that must be made. One should review the state law in each state using the following analysis in order to show that the trust fund provision of the agreement of indemnity provides an express trust under the relevant state law. See note 83, infra., for relevant cases involving express trusts in the States of Virginia, New Jersey, North Carolina and Ohio.

⁷² Salem Church of United Brethren v. Numsen, 59 A.2d 757 (Md. 1948).

⁷³ Mathias v. Fowler, 93 A. 298 (Md. 1915).

⁷⁴ Daugherty v. Daugherty, 2 A.2d 433 (Md. 1938); Gray v. Harriet Lane Home, 64 A.2d 102 (Md. 1949).

⁷⁵ Mitchell v. Colburn, 61 Md. 244 (1884).

⁷⁶ Restatement (Second) Trusts § 2 (1959); Klein v. Bryer, 177 A.2d 412, 413-414 (Md. 1961).

to create the trust is apparent and the creator of the trust is competent.⁷⁷ Regardless of whether the principal understands the legal characteristics of a trust or knows that the intended relationship was a trust, the trust can nevertheless be established by all of the circumstances surrounding the transaction.⁷⁸ Clearly, where the language of the trust fund provision of the agreement of indemnity explicitly sets forth the exact nature of the trust relationship, the intention to create a trust is established.

- The remaining elements for the establishment of a trust are also contained in the trust fund provision of the agreement of indemnity. Although the trust property or res in the form of the Contract Funds was not in existence at the time the agreement of indemnity was executed, the mere fact that the trust res would be created later is not fatal to the establishment of the trust, nor does the trust fail for lack of consideration, for a contract to create a trust for a future res when acquired is appropriate if the settlor receives sufficient consideration.⁷⁹ Here, the surety's issuance of the bonds for the principal as settlor of the trust in reliance upon the agreement of indemnity and its provisions is fair and adequate consideration. Supported by this consideration, the agreement of indemnity should be construed as a contract to hold the property (the Contract Funds) in trust when acquired and as giving the beneficiaries equitable rights in the property (the trust res) from the moment of its acquisition.

- The trust fund provision of the agreement of indemnity also clearly sets forth the trust's beneficiaries and identifies a trustee. The trust fund provision sufficiently identifies "all persons to whom the Principal incurs obligations in the performance of any contract or contracts for which the Surety would be liable under any Bond or Bonds" and the surety as beneficiaries. The specific identity of the beneficiaries may be ascertained.⁸⁰ Moreover, the settlor of the trust, in this case the principal, who may properly serve as the trustee, can be identified as the trustee from the language of the trust fund provision.⁸¹

- Notwithstanding the clear case for the imposition of a trust upon the Contract Funds under the trust fund provision of the agreement of indemnity, there remains a single and essential concept of trust law that must be considered and dealt with. Specifically, in order to create a completed and thus enforceable trust of personalty, such as the Contract Funds, there must be delivery, or the equivalent of delivery, of the trust res to the trustee.⁸² Once the Contract Funds are paid to the principal, as the Debtor, or the Trustee, delivery has occurred and the Contract Funds must be held in trust by the Debtor or the Trustee.⁸³

⁷⁷ Killen v. Houser, 210 A.2d 527, 530 (Md. 1965); Restatement (Second) Trusts § 2 (1959).

⁷⁸ Restatement (Second) Trusts § 23 (1959), cmt. a.

⁷⁹ Klein, 177 A.2d at 414.

⁸⁰ Killen, 210 A.2d at 531.

⁸¹ See Restatement (Second) Trusts § 100 (1959), cmt. a.

⁸² Schenker v. Moodhe, 200 A. 727, 728 (Md. 1939).

⁸³ While each state may have slightly different elements for the creation of an express trust, most states have case law that is similar to Maryland's. For example, the following cases in the following states create obligations similar to those in Maryland for the creation of an express trust:

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E. The Surety's Subrogation Rights.⁸⁴
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(a) In the State of Virginia: Peal v. Luther, 97 S.E.2d 668 (Va. 1957); Woods v. Stull, 30 S.E.2d 675 (Va. 1944); Broadbudd v. Gresham, 26 S.E.2d 33 (Va. 1943).

(b) In the State of New Jersey: Kronisch v. The Howard Sav. Inst., 382 A.2d 64 (N.J. Super. 1977); In re Estate of Kovalyshyn, 343 A.2d 852 (N.J. Super. 1975).

(c) In the State of North Carolina: Wachovia Bank & Trust Co. v. Taylor, 120 S.E.2d 588 (N.C. 1961); Moore v. Jones, 261 S.E.2d 289 (N.C. App. 1980); Starling v. Taylor, 161 S.E.2d 204 (N.C. App. 1968); Young Women's Christian Ass'n of Asheville, N.C., Inc. v. Morgan, 189 S.E.2d 169 (N.C. 1972).

(d) In the State of Ohio: Brown v. Concerned Citizens for Sickle Cell Anemia, Inc., 382 N.E.2d 1155 (Ohio 1978); Guardian Trust Co. v. Kirby, 199 N.E. 81 (Ohio Ct. App. 1935).

⁸⁴ Frequently, third parties may compete with the surety for the Contract Funds on the contracts bonded by the surety for the principal. The surety may utilize its subrogation rights to the rights of others in asserting the surety's claims to the Contract Funds, and compete with the claims of:

- The owner as obligee;
- The obligee as taxing authority;
- The principal/contractor;
- Third-party beneficiary claimants under the payment bond;
- Assignees/lenders (banks);
- Trustees in bankruptcy/debtors-in-possession;
- Taxing authorities other than the obligee; and
- Other creditors of the principal, including judgment creditors.

Much has been written about this subject. See generally, THE SUBROGATION DATABASE: CASES CONCERNING THE SUBROGATION RIGHTS OF THE CONTRACT BOND SURETY (George J. Bachrach, ed., TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION 1995) (hereinafter referred to as the "The Subrogation Database"). The Subrogation Database contains all of the cases concerning the subrogation rights of the surety organized in an Outline (Matrix) form. The Outline (Matrix) lists the significant issues concerning the subrogation rights of the surety, and provides a framework or structure to identify, organize and categorize all cases concerning the surety's subrogation rights; *see also* George J. Bachrach, *The Surety's Rights to Obtain Salvage-Exoneration, Reimbursement, Subrogation, and Contribution* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual meeting on August 3, 1997); George J. Bachrach and John V. Burch, *The Surety's Subrogation Rights*, in THE LAW OF SURETYSHIP (Edward G. Gallagher, ed. 1993); SUBROGATION RIGHTS OF THE CONTRACT BOND SURETY (George J. Bachrach, ed., TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION 1990); Daniel Mungall, Jr., *The Subrogation Rights of the Contract Bond Surety - Some Basics*, in SUBROGATION RIGHTS OF THE CONTRACT BOND SURETY (George J. Bachrach ed., 1990).

- If the surety has no rights of its own to the Contract Funds, it may have the ability to use the rights of others as a result of the surety's legal and equitable rights of subrogation.⁸⁵ The problem with the surety relying on its subrogation rights to the rights of others is twofold:

- • The rights of others, whether they are contractual, statutory, common law or equitable rights, differ in every instance and circumstance. The surety must review each and every contract between the various obligees and the Debtor, as principal, the various subcontracts and purchase orders between the Debtor, as principal, and its subcontractors and suppliers, and any other statutory, legal and equitable rights that the various parties may have under state law.

⁸⁵

- The surety that performs under its performance bond or pays subcontractors and suppliers under its payment bond has rights to the remaining Contract Funds, including progress payments and retainage. In Prairie State Nat'l. Bank v. United States, 164 U.S. 227 (1896), the Supreme Court found that the surety who was compelled to complete a government contract upon the principal's default in performance was entitled to be reimbursed out of the contract funds pursuant to its equitable rights of subrogation. In Henningesen v. United States Fid. and Guar. Co., 208 U.S. 404 (1908), the Supreme Court found that the surety had the same equitable right of subrogation to the contract funds for its payment of the claims of laborers and materialmen as the surety in Prairie State had for its payments in completing the contract.

- The subrogation rights of a surety that pays the claims of its principal's subcontractors and suppliers have been clearly set forth in Pearlman v. Reliance Insurance Co., 371 U.S. 132 (1962). In Pearlman, the surety met its obligations on its bond by paying the claims of its principal's laborers and materialmen. In a contest with a bankruptcy trustee, the surety prevailed against the trustee and received the remaining contract funds. Initially, the Supreme Court stated:

- Ownership of property rights before bankruptcy is one thing; priority of distribution in bankruptcy of property that has passed unencumbered into a bankrupt's estate is quite another. Property interests in a fund not owned by a bankrupt at the time of adjudication, whether complete or partial, legal or equitable, mortgages, liens, or simple priority of rights, are of course not a part of the bankrupt's property and do not vest in the trustee. The Bankruptcy Act simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors. So here if the surety at the time of adjudication was, as it claimed, either the outright legal or equitable owner of this fund, or had an equitable lien or prior right to it, this property interest of the surety never became a part of the bankruptcy estate to be administered, liquidated, and distributed to general creditors of the bankrupt.

- 371 U.S. at 135-136.

- After reviewing several of its prior decisions, the Supreme Court stated:

- We therefore hold in accord with the established legal principles stated above that the Government had a right to use the retained fund to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of the fund; that the contractor, had he completed its job and paid his laborers and materialmen, would have become entitled to the fund; and that the surety, having paid the laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it. Consequently, since the surety in this case has paid out more than the amount of the existing fund, it has a right to all of it.

- 371 U.S. at 141-142.

- - The surety seeking to enforce its subrogation rights is at the mercy of the laws of every state. The surety must review all of the cases of every state in which the bonds have been written to determine whether the surety actually has any subrogation rights under the particular facts and circumstances of each case.⁸⁶

- - The following is a sample of the kinds of rights to which a surety may be subrogated that may provide the surety with a sufficient “interest” in the Contract Funds to seek adequate protection for the Debtor’s use of the Contract Funds under section 363 of the Bankruptcy Code.

- - 2. The rights of the owner/obligee (the “Obligee”). The Obligee has rights against the Debtor, as principal, the Contract Funds, and other obligations to which the surety may be subrogated. Those rights include the following.

- - - The Obligee’s contractual rights to the Contracts Funds.
 - The Obligee’s contractual and common law setoff rights.
 - The governmental Obligee’s equitable obligations.

- - (b) The Obligee’s rights to the Contract Funds under the underlying contract with the Debtor.

- - The Debtor’s rights to receive the Contract Funds are governed by its underlying contract with the Obligee. The Debtor gets no better interest in the Contract Funds after filing the bankruptcy proceeding than the Debtor, as principal, had to the Contract Funds prior to filing the bankruptcy proceeding.⁸⁷ To the extent that the provisions in the underlying contract restrict the Debtor’s rights to the Contract Funds, the Debtor has not “earned” the Contract Funds, and is not entitled to collect the Contract Funds until the Debtor complies with the provisions of the underlying contract.⁸⁸

- - Frequently, a construction contract between the Obligee and the Debtor, as principal, contains a number of provisions along the following lines:

- - - The Debtor’s obligation to perform the work under the contract, and, in the event of the Debtor’s failure to perform, the right of the Obligee to default terminate the Debtor and use the remaining Contract Funds to complete the performance of the work on the contract;

- - - The Debtor’s obligation to pay its subcontractors, suppliers, laborers and materialmen;

⁸⁶ See generally, The Subrogation Database, supra note 84, and the papers described therein.

⁸⁷ See supra text accompanying note 24.

⁸⁸ In re Modular Structures, Inc., 27 F.3d 72 (3d. Cir. 1994).

- • A contractual trust fund provision requiring the Debtor to hold any payments it receives from the Obligee in trust for the payment of the Debtor's subcontractors, suppliers, laborers and materialmen on the contract;

- • A contractual condition precedent to any partial and final payments by the Obligee to the Debtor that the Debtor must provide to the Obligee releases and waivers of lien from its subcontractors, suppliers, laborers and materialmen, and, frequently, a consent of the surety for final payment;

- • The Debtor's obligation to provide an affidavit that there are no claims, obligations or liens outstanding or unsatisfied for labor, services, materials, equipment, etc. furnished or incurred for or in connection with the contract;

- • The Obligee's right to withhold payment to the Debtor if there is evidence of nonpayment for any labor, services, materials, equipment, etc., or if any liens or claims have been filed by the subcontractors, suppliers, laborers or materialmen as a result of nonpayment; and

- • The Obligee's right to use the withheld payments to pay the claims of the subcontractors, suppliers, laborers and materialmen who have not been paid by the Debtor on the contract.

- Because of these kinds of contract provisions, the surety, pursuant to its subrogation rights, may have an interest in the Contract Funds to the extent that they are necessary for the performance of the work under the contract and for the payment of the bills of subcontractors and suppliers under the contract for which the surety may become liable under its bonds.

- The surety's rights to the Contract Funds when such contract provisions exist are fully discussed in the case of In re Modular Structures, Inc.⁸⁹ Modular Structures involved a fight over the remaining contract funds between the surety and a secured creditor (bank) claiming through the debtor. The court reviewed the terms of the contract between the debtor and the owner to determine whether the debtor was entitled to final payment under the terms of the contract. The court specifically cited the following provision of the contract:

- Neither final payment nor any remaining retained percentage shall become due until the Contractor submits to the Architect (1) an affidavit that payrolls, bills for materials and equipment, and other indebtedness connected with the Work for which the Owner or the Owner's property might be responsible or encumbered (less amounts withheld by Owner) have been paid or otherwise satisfied,...(4) consent of surety, if any, to final payment and (5) if required by the Owner, other data establishing payment or satisfactions of obligations, such as receipts, releases and waivers of liens, claims, security interests or encumbrances arising out of the Contract to the extent and in such form as may be designated by the Owner.⁹⁰

⁸⁹ 27 F.3d 72 (3rd Cir. 1994).

⁹⁰ Id. at 75.

- The court found that the debtor was obligated to pay its subcontractors and submit proof thereof before it could receive final payment from the owner. Because the debtor could not satisfy these conditions precedent, the court held that none of the contract funds in the hands of the owner were due or owing to the debtor, and thus could not be properly considered to be part of the debtor's bankruptcy estate.⁹¹

- Other bankruptcy courts have come to similar conclusions. In In re Pacific Marine Dredging & Construction,⁹² the court found that the contract between the debtor and the owner required the debtor to promptly pay its subcontractors for the work that they provided under the contract.⁹³ With respect to final payment, the contract stated as follows:

- Before the owner pays the contractor his final payment for the work, the contractor shall sign and deliver to the owner a release of liens and claims sworn to under oath and duly notarized. The release shall state that the contractor satisfied all claims and indebtedness of every nature in any way connected with the work, including...amounts due to sub-contractors, accounts for labor performed and materials furnished...⁹⁴

- When the owner received notice that various subcontractors had not been paid, it withheld the progress payment and the final retainage from the debtor. The surety paid the claims of subcontractors and suppliers of the debtor under the contract, which amounts were significantly in excess of the remaining contract funds.

- On the issue of whether the remaining contract funds were the property of the debtor's estate, the court said:

- Generally, 11 U.S.C. § 541 provides that all legal or equitable interests of the debtor in property as of the commencement of the case becomes property of the estate. Here, debtor breached the contract by not paying its sub-contractors. Plaintiff [the owner] exercised its statutory and contractual rights and withheld the final payment.

- This court agrees with other courts that have found that the contractor's failure to pay for labor and materials is just as much a failure to perform and carry out the terms of the contract as an abandonment of the work. United States v. Commonwealth of Pennsylvania, Department of Highways, 349 F. Supp. 1370, (E.D. Pa. 1972); Atlantic Refining Company v. Continental Gas Co., 183 F. Supp. 478 (W.D. Pa. 1960). In short, plaintiff [the owner] is not contractually obligated to pay the fund to debtor. Due to debtor's breach of contract, the debtor does not have any legal or equitable interest in the fund. Accordingly, the fund is not property of the estate.

⁹¹ Id. at 76-77.

⁹² 79 B.R. 924 (Bankr. D. Or. 1987).

⁹³ Id. at 926.

⁹⁴ Id. at 926.

- All monies interpled by plaintiff were properly withheld under plaintiff's [the owner's] statutory and contractual rights, as the final payment was not payable to debtor until plaintiff received assurance that debtor had paid all sub-contractors by providing a notarized release stating that the contractor has satisfied all claims of laborers and materialmen. Debtor never provided such a release. Further, the fund was properly withheld because debtor materially breached the contractual provision which required prompt payment to laborers and materialmen. Finally, plaintiff was well within its statutory rights, upon receiving notice of unpaid claims, to withhold the funds.⁹⁵

• In summary, the Debtor may have no interest in the remaining Contract Funds from the contract. If the Debtor is unable to perform the contract or pay the bills of its subcontractors, suppliers, laborers and materialmen on the contract, and the surety becomes liable under its bonds as a result, the surety would, pursuant to the various terms of the Debtor's contract with the Obligees and the surety's rights of subrogation, have rights in the remaining Contract Funds.⁹⁶ As stated by the court in Modular Structures:

- In the present case, Modular [the contractor] did not fulfill its contractual obligation to pay all of its subcontractors. First Indemnity, as surety for Modular, is required to pay any subcontractor not paid by Modular. The funds held by the Salvation Army [the owner] must be employed to satisfy these claims, either in direct payments to the subcontractors or in reimbursement to First Indemnity for the payments it has made as surety, standing in the Salvation Army's shoes, to the subcontractors.⁹⁷

(c) The Obligees' contractual and common law setoff rights.

• Before the Obligees are required to turnover the Contract Funds to the Debtor under section 542 of the Bankruptcy Code, the Obligees may setoff any claims it may have against the Debtor arising out of any other contract, agreement or at common law under section 553 of the Bankruptcy Code.⁹⁸ To the extent that

⁹⁵ Id. at 929.

⁹⁶ A condition precedent for the Debtor to obtain turnover of the Contract Funds from the Obligees, *i. e.*, payment under the terms of the contract, under section 542 of the Bankruptcy Code is for the Debtor to provide adequate protection to the Obligees for the Debtor's receipt and use of the Contract Funds under sections 361 and 363 of the Bankruptcy Code. That adequate protection must be the Debtor's compliance with the terms of the contract, including the Debtor's performance of the work required under the contract and payment of the Debtor's subcontractors and suppliers who have performed labor and/or supplied materials on the project.

⁹⁷ 27 F.3d at 77.

⁹⁸ 11 U.S.C. § 542(b). The Obligees always has the right to withhold payments under a particular contract with the Debtor if the Debtor has not complied with the terms of that particular contract. The Obligees may have other contractual or common law setoff rights against the Debtor. Whether the Obligees has a contractual or common law setoff right against the Debtor, that setoff right may not be exercised without the Obligees' obtaining relief from the automatic stay under section 362(d) of the Bankruptcy Code. 11 U.S.C. § 362(a)(7).

the Obligees may have several contracts with the Debtor, if those contracts contain setoff provisions allowing the Obligees to setoff its losses from one contract with the Debtor against monies due to the Debtor on separate contracts with the Obligees, the surety incurring a loss on one of the contracts may be subrogated to the Obligees' contractual setoff rights to monies due to the Debtor on the separate contracts. Furthermore, the Obligees may have common law setoff rights against the Debtor to which the surety may be subrogated.⁹⁹

- - (d) The governmental Obligees' equitable obligation to pay the Debtor's subcontractors and suppliers.

- - Even in the absence of any contractual obligation of the Debtor to the Obligees to pay the Debtor's subcontractors and suppliers, the Obligees, especially governmental Obligees, may have an equitable obligation to see that the subcontractors and suppliers of the Debtor are paid from the Contract Funds.

- - The subcontractors, suppliers, laborers and materialmen have an equitable interest in any Contract Funds that may be paid by the federal government to the Debtor. In Universal Bonding Insurance Co. v. Gittens & Sprinkle Enterprises, Inc.,¹⁰⁰ the court found that while laborers and materialmen may have no "enforceable" rights against the contract funds retained by the federal government, the equitable interest retained by the laborers and materialmen is such that they become trust fund beneficiaries of the contract balances once they have been paid to the debtor. The court held:

- - [T]he funds owed by the federal agencies to Gittens should be paid to Gittens as debtor in possession pursuant to the broad language of section 541 of the Code. We also hold that once the funds are received by Gittens, they will constitute an equitable trust for the benefit of laborers and materialmen. [The surety] may become a beneficiary of this trust by fulfilling its obligation to compensate the laborers and materialmen.¹⁰¹

- - - 3. The rights of the third-party beneficiaries under the payment bonds, namely subcontractors and supplies with claims against the payment bonds ("Claimants").¹⁰²

- - - The Claimants may have direct claims against the Obligees and/or the Contract Funds to which the surety may be subrogated. Those rights include the following.

- - - - The Claimants' direct claims against the Obligees and/or to the Contract Funds.

⁹⁹ Transamerica Ins. Co. v. U.S., 989 F.2d 1188 (Fed. Cir. 1993).

¹⁰⁰ 960 F.2d 366 (3rd Cir. 1992).

¹⁰¹ Id. at 376.

¹⁰² See generally, Edward Graham Gallagher, *Unpaid Subcontractor's or Supplier's Right to Payment Out of Contract Funds*, 10 THE CONSTR. LAW 9 (1990); Gordon S. Elkins, *Rights of Subcontractors, Laborers and Materialmen to Contract Balances*, 18 FORUM 695 (1983).

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- • The Claimants' contract rights to the Contract Funds.
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- • The Claimants' statutory trust fund rights to the Contract Funds.
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- • The Claimants' other statutory rights against the Obligee and/or to the Contract Funds.
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- • The Claimants' equitable interest and right to the Contract Funds.
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(b) Claimants may have direct claims, including mechanics' lien rights, against the Obligee and/or the Contract Funds to which the surety may be subrogated.

- - A surety may be subrogated to the rights of the Debtor's subcontractors and suppliers who have state law mechanics' lien rights against the Obligee or the property of the Obligee. The problem that arises for the surety is that no mechanics' lien claim may exist if the subcontractor or supplier fails to perfect its mechanics' lien rights properly under state law.¹⁰³ If the Claimants have direct claims against the Obligee or the Contract Funds that are valid and enforceable notwithstanding the Debtor's filing of its bankruptcy proceeding, upon payment of the claims of the Claimants, the surety should be subrogated to those direct claim rights against the Obligee or the Contract Funds.

(c) With respect to private and public contracts, there may be express provisions in the contract and the payment bond protecting the rights of the Claimants to the Contract Funds to which the surety may be subrogated.

- - Although there appears to be no case law on point involving a surety as the subrogee, there are cases finding that a general contractor's direct payments to a Debtor subcontractor's sub-subcontractors and/or suppliers are not property of the Debtor's estate.¹⁰⁴ Once again, in order to ascertain

¹⁰³ See In re Wm. Cargile Contractor, Inc., 151 B.R. 854 (Bankr. S.D. Ohio 1993). [The surety was not subrogated to any lien rights of the subcontractors because their mechanics' liens filed post-petition were unenforceable and violated the automatic stay. Under Ohio law, mechanics' liens are only effective once filed and do not relate back to date that the subcontractor commenced work.]; State of Ohio ex rel. Star Supply v. City of Greenfield, 528 F. Supp. 955 (S.D. Ohio 1981). [The surety had no right to the retainage as subrogee of subcontractors and/or suppliers because they had not complied with the requirements of the mechanics' lien statute and all claims under the statute were time-barred.]

¹⁰⁴ See In re Arnold, 908 F.2d 52 (6th Cir. 1990) [The contractor's payments to the supplier of the debtor subcontractor are not property of the debtor's estate because they arose from the contractor's obligation to the state owner to pay suppliers on the project and not from the obligations owed by the debtor subcontractor to the supplier.]; Gold v. Alban Tractor Co., Inc., 202 B.R. 424 (Bankr. E.D. Mich. 1996) [same]; In re Underground Storage Tank Technical Services Group, Inc., 1997 WL 532787 (Bankr. E.D. Mich. 1997) [The contractor had an indirect obligation to pay the debtor subcontractor's sub-subcontractor independent of any obligations owed by debtor subcontractor because the Miller Act requires the contractor to furnish a payment bond and the contractor was obligated to reimburse the surety for payments the surety might have to make to any sub-subcontractor that filed a payment bond claim.]

whether the surety has any rights, the surety must review the express provisions in the contract and the payment bond.

- - (d) Claimants may have state law statutory trust fund rights against the Contract Funds to which the surety may be subrogated.

- - Many states have trust fund statutes that give subcontractors and suppliers a trust interest in any contract funds paid by an obligee to a contractor or by a contractor to a subcontractor. The State of Maryland has such a statute (the “Maryland Trust Fund Statute”).¹⁰⁵

- - The Maryland Trust Fund Statute provides in part as follows:

- - - *Monies to be held in trust.* - Any moneys paid under a contract by an owner to a contractor, or by the owner or contractor to a subcontractor for work done or materials furnished, or both, for or about a building by any subcontractor, shall be held in trust by the contractor or subcontractor, as trustee, for those subcontractors who did work or furnished materials, or both, for or about the building, for purposes of paying those subcontractors.¹⁰⁶

- - The Maryland Trust Fund Statute applies to all contracts that are subject to the Maryland “Little Miller Act” and the Maryland mechanics’ lien statutes.¹⁰⁷

- - - Because of the existence of the Maryland Trust Fund Statute, the surety may have an interest in the Contract Funds constituting cash collateral of the Debtor as provided in section 363 of the Bankruptcy Code. The Maryland Trust Fund Statute is similar to the New Jersey Trust Fund Act, which has been held to give an interest to a surety in the Contract Funds claimed by a Debtor.

- - - In Universal Bonding Insurance Co. v. Gittens & Sprinkle Enterprises, Inc.,¹⁰⁸ the Third Circuit Court of Appeals addressed the surety’s interest in the contract funds claimed by a New Jersey debtor from the contracts bonded by the surety. New Jersey has a statutory trust fund. The court found that the contract balances were subject to the New Jersey Trust Fund Act and must be paid over to the debtor (“Gittens”) as debtor-in-possession. But the court did:

- - - - not agree with the bankruptcy court and the district court that monies that Gittens has received or will receive from the state and municipal agencies after the filing of its petition may be allocated to, and be distributed to, general creditors or used by Gittens in its effort to reorganize. Rather, we hold that Gittens, once it has received

¹⁰⁵ MD. CODE ANN. REAL PROP. §§ 9-201 to 9-204 (1995).

¹⁰⁶ MD. CODE ANN. REAL PROP. § 9-201(a) (1995).

¹⁰⁷ MD. CODE ANN. REAL PROP. § 9-204 (1995).

¹⁰⁸ 960 F.2d 366 (3rd Cir. 1992).

the monies from the various agencies, must hold those monies subject to the statutory trust imposed by the New Jersey Trust Fund Act.¹⁰⁹

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- The court cited section 541(d) of the Bankruptcy Code¹¹⁰ and In re Glover Construction Company,¹¹¹ for the proposition that “property in which the debtor holds only legal title, and does not hold an equitable interest, such as trust funds, is included in the bankrupt’s estate only to the extent of the debtor’s legal title to the property and not to the extent of any interest in the property that the debtor does not hold.”¹¹² Furthermore, the court stated:

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- It is a basis tenet of trust law that the trustee has a legal interest in the property he holds, which requires its inclusion under § 541(a). However, the Bankruptcy Code does not overlook the outstanding beneficial interests. According to § 541(d) the property comes into the estate subject to those interests.¹¹³

- Whether Gittens received the contract balances either before or after the filing of its bankruptcy proceeding, the court determined that there was no difference in the trust fund nature of the contract balances from the New Jersey state and municipal agencies under the New Jersey Trust Fund Act. The court found that Gittens’ right to the contract balances did not change the moment that Gittens filed its bankruptcy proceeding, stating.

- Gittens’ bankrupt estate thus obtains no greater ownership right over the payments than Gittens itself would have acquired prior to the bankruptcy filing. Gittens’ bankrupt estate may retain legal title over the trust, but the beneficiaries of the trust (namely, the laborers, materialmen and the surety after satisfying the claims of the laborers and materialmen), may reclaim their equitable interests in the trust fund so created through bankruptcy court proceedings.¹¹⁴

- Finally, with respect to the New Jersey Trust Fund Act, the court went on to hold:

- [M]onies received by Gittens from the state and municipal agencies constitute trust funds for the benefit of laborers and materialmen. Moreover, when and if [the surety]

¹⁰⁹ Id. at 371.

¹¹⁰ Section 541(d) of the Bankruptcy Code provides:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest...becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor’s legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

¹¹¹ 30 B.R. 873 (Bankr. W.D. Ky. 1983).

¹¹² 960 F.2d at 371.

¹¹³ Id. at 371.

¹¹⁴ Id. at 372.

pays Gittens' indebtedness to laborers or materialmen, it may pursue the statutory remedies of the laborers or materialmen by proceeding against such funds.¹¹⁵

- When state law provides for a statutory trust over the Contract Funds such as the Maryland Trust Fund Statute, the Debtor must hold all Contract Funds in trust for the benefit of its subcontractors, suppliers, laborers and materialmen. By virtue of its subrogation rights, the surety has an interest in the Contract Funds for which it is entitled to adequate protection. The Debtor's only right to the Contract Funds is to hold the Contract Funds in trust to protect the interests of the beneficiaries, either the subcontractors, suppliers, laborers and materialmen, or the surety, which may be liable to the subcontractors, suppliers, laborers and materialmen pursuant to its obligations under the payment bonds.

- (e) Claimants may have other state law statutory rights against the Obligee or the Contract Funds, including stop notice/withhold/direct payment rights, to which the surety may be subrogated.

- It is beyond the scope of this paper to list all of the potential statutory rights that Claimants may have against the Obligee and/or the Contract Funds that would entitle the Claimants to receive direct payments of the Contract Funds from the Obligee or others, thereby bypassing the rights, if any, of the Debtor. To the extent that such state statutes exist, and assuming that the Claimants have perfected their rights under the statutes, the surety would be entitled to be subrogated to the rights of the Claimants against the Obligee and the Contract Funds under state law.

- For example, Kentucky law, by statute (the "Kentucky Statute"), imposes an obligation on the Debtor to apply payments from an obligee to the claims of those who have supplied labor or materials to the obligee's project.¹¹⁶ The Kentucky Statute states as follows:

- (1) Any contractor, architect or other person who builds, repairs or improves the property of another under such circumstances that a mechanics' or materialman's lien may be imposed on the property shall, from the proceeds of any payment received from the owner, pay in full all persons who have furnished material or performed labor on the property.

- (2) If any payment by the other to the contractor, architect or other person is not sufficient to pay in full all bills for material and labor, then such claims shall be paid on a pro rata basis to the amount of payments received, unless otherwise agreed between the contractor, architect or other person and the holder of the claim for material or labor.

- (3) This section shall not apply where persons furnishing material or performing labor have waived in writing their right to file mechanics' or materialmen's liens.

- The Kentucky Statute is not a trust fund statute. However, the Kentucky Statute has been held to impose "upon an individual building contractor a 'known legal obligation' (i. e., to pay in full all claims for material and labor involving a particular job out of the payments received from the

¹¹⁵ Id. at 373-74.

¹¹⁶ KY. REV. STAT. ANN. § 376.070.

owner),”¹¹⁷ and that the Kentucky Statute “imposes upon building contractors a fiduciary duty” with respect to the proceeds of any payment received from the obligee.¹¹⁸

- Under the Kentucky Statute, the surety may argue that the Debtor has a statutory obligation to apply any payments it receives from an Obligee to pay the claims of those who have supplied labor and materials to the Obligee’s project. Because the surety would be liable to the Claimants under the payment bond in the event of the Debtor’s failure to pay the Claimants, the surety should be subrogated to the statutory rights of the Claimants. The Kentucky Statute, and any other state law statutory rights that the Claimants may have against the Obligee or the Contract Funds, provides rights to which the surety may be subrogated in contending that the surety has an interest in the Contract Funds.

- (f) The Claimants’ equitable interest and right to the Contract Funds in the hands of the governmental Obligee.

- The Claimants may have an equitable interest and right in any Contract Funds that may be held by a governmental Obligee that may be “owed” to the Debtor. Those Contract Funds must be used to pay the Debtor’s obligations to its subcontractors and suppliers under its contract with the governmental Obligee.¹¹⁹

F. Summary.

- A surety is obligated under its performance bond to the Obligee to pay for the performance of the work under the contract in the event of a default by the Debtor. A surety is obligated under its payment bond to pay the claims of subcontractors, suppliers, laborers and materialmen in the event that the Debtor is unable to pay their claims. The surety that performs under its performance bond and pays under its payment bond has a number of contractual and subrogated “interests” in the Contract Funds held by the Obligee. The surety’s subrogation rights are numerous because of the various contractual, statutory, legal and equitable rights of the Obligee and the Claimants against the Debtor and the Contract Funds to which the surety may be subrogated. The surety must be diligent in examining the various contractual, statutory, legal and equitable rights of the Obligee and the Claimants against the Debtor and the Contract Funds in order for the surety to prove that the surety has an interest in the Contract Funds. If the surety meets its burden of proof concerning the validity, priority and extent of the surety’s “interest” in the Contract Funds, the surety may seek adequate protection for the Debtor’s use of the Contract Funds pursuant to section 363(e) of the Bankruptcy Code.

III.WHAT CONSTITUTES ADEQUATE PROTECTION TO THE SURETY •FOR THE DEBTOR’S USE OF THE CONTRACT FUNDS?

- If the surety can meet its burden of proof under section 363(o)(2) of the Bankruptcy Code concerning the validity, priority and extent of its interest in the Contract Funds, then the burden

¹¹⁷ Kentucky v. Laurel Company, 805 F.2d 628, 633 (6th Cir. 1986) (citing Blanton v. Commonwealth, 562 S.W.2d 90, 91-93 (Ky. App. 1978).

¹¹⁸ In re Jeanes Mech. Contrs., Inc., 32 B.R. 657, 658 (Bankr. W.D. Ky. 1983).

¹¹⁹ See Section IV.C. 1. (c), supra.

of proof on the adequate protection of the surety's interest in the Contract Funds falls on the Debtor under section 363(o)(1) of the Bankruptcy Code. The bankruptcy court will adequately protect the surety for the Debtor's use of the Contract Funds to ensure that the surety's liabilities under its bonds are paid with the Contract Funds.

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B. Adequate Protection Generally.

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• Section 361 of the Bankruptcy Code discusses when adequate protection is required under sections 362, 363 and 364 of the Bankruptcy Code. Section 361 focuses on the financial protection granted to an entity with an "interest" in the "cash collateral" for the Debtor's use of that "cash collateral." The bankruptcy court is allowed to grant other relief to such an entity that results "in the realization by such entity of the indubitable equivalent of such entity's interest in such property."¹²⁰

• At the time that the surety executes the bonds for the principal, the surety expects that, in the event of the Obligee's default termination of the principal's right to perform, and the surety's performance of the obligations of its principal under the performance bond and/or the payment bond, the surety will receive payment of the Contract Funds from the Obligee as a result of and to the extent of the surety's performance. Therefore, a surety is not really interested in adequate protection that substitutes other potential collateral for the Contract Funds. Rather, the surety wants the Contract Funds themselves to be used to pay the bills for which the surety would otherwise be liable under its bonds.

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C. Adequate Protection for the Surety.

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• Bankruptcy courts have addressed the surety's need for adequate protection for the Debtor's use of the Contract Funds. In In re Ram Construction Company, Inc.,¹²¹ the court referred to an earlier preliminary order which provided the surety with adequate protection by limiting the debtor's payments to those expenses required to keep the bonded contracts ongoing. The court stated:

• American States was permitted to control RAM's payments of these expenditures to assure that the owners' monies received was dedicated to the ongoing expenses of an owner's contract.

• Additionally, the Debtor was ordered to provide an accounting for each contract, so that income and expenses could be reviewed by Equibank and others. The Debtor was not permitted to use these monies to pay for equipment and other expenses not necessary on the ongoing contracts.

• Also, salary payments to the Debtor's stockholders-officers and their relatives was limited by this Order and a following Order.

• This Order was entered for several reasons. The Court believed that the surety would not be adequately protected if the Debtor was free to pay money received from the owners for Debtor expenses on other contracts, etc. Additionally,

¹²⁰ 11 U.S.C. § 361(3).

¹²¹ 32 B.R. 758 (Bankr. W.D. Pa. 1983).

if the Court did not fashion such protection, the Court believed the surety would request a lifting of the stay and put another contractor on the job and claim the balances owed by the owner to the Debtor. Under the facts represented, the Court believed the surety would succeed and RAM's Chapter 11 would have a short life.¹²²

- In In re Glover Construction Co., Inc.,¹²³ the court found that progress payments were property of the debtor's estate under section 541 of the Bankruptcy Code, and that the surety had an interest in the contract funds. In citing favorably to the RAM decision, the court reiterated:

- [T]he same attitude we have expressed in numerous rulings in open court in the Glover case: that the stream of payments cannot be diverted from the jobs to which they relate. We have consistently ruled, on various motions, that payments must be first applied to those claims on which the surety is or may become liable before the Chapter 11 debtor can be paid the first discretionary dollar.¹²⁴

- Subsequently, after discussing the trust nature of the contract funds, the court stated:

- To the extent that the surety is actually seeking "adequate control of the debtor ... so that contract proceeds go first to contract claims," American States is seeking a protection which has already been extended by the Court in a series of interim rulings at every stage of this proceeding. Until such time as it is possible to precisely quantify the ultimate liability of surety, it will be the unrelenting demand of this Court that progress payments be disbursed in the following order:

- to bona fide claims against the jobs, for the period in question, concerning which American State may become liable, and

- subject to the availability of periodic surplusages, to those items of the contractor's job-related operating and overhead expenses which are ordinary and necessary, most stringently viewed.¹²⁵

D. The Surety's Contractual Rights to Adequate Protection.

- While the bankruptcy courts appear willing to provide adequate protection to the surety for the Debtor's use of the Contract Funds, the surety may have contractual or other agreements in existence with the Debtor to convince the bankruptcy court to provide adequate protection to the surety. The following are two examples:

2. The agreement of indemnity between the surety and the Debtor may provide that the Debtor will, upon demand, deposit all checks and vouchers received from the Obligees

¹²² Id. at 759.

¹²³ 30 B.R. 873 (Bankr. W.D. Ky. 1983).

- ¹²⁴ Id. at 880.

¹²⁵ Id. at 882.

representing Contract Funds into a joint control account with the surety. While the automatic stay of section 362 of the Bankruptcy Code prevents the surety from enforcing those rights under the agreement of indemnity, if the surety can show the bankruptcy court that it has an interest in the Contract Funds under section 363 of the Bankruptcy Code, the bankruptcy court may well compel the Debtor to comply with the terms of the agreement of indemnity, and establish a joint control account as adequate protection for the surety.

- 3. If, prior to the commencement of the bankruptcy proceeding, the surety and the Debtor have entered into a joint control account agreement for the control of the Contract Funds, or if such a joint control account exists pursuant to a financing arrangement between the surety and the Debtor, the surety may request as adequate protection that the already existing arrangements be continued after the commencement of the Debtor's bankruptcy proceeding.

- - In each instance, the concept of a joint control account requiring the signature of a representative of the Debtor and the signature of a representative of the surety for any withdrawal from the joint control account should give the surety adequate protection for the Debtor's use of the Contract Funds for the performance of the contracts and for the payment of all bills of subcontractors and suppliers on the contracts for which the surety would be liable under its bonds.

- - E. Financing the Debtor in Bankruptcy.

- - The surety's financing of the Debtor during the bankruptcy proceeding is beyond the scope of this paper. Other articles and papers have dealt with the issue of the surety's financing of its principal in a bankruptcy proceeding.¹²⁶ However, a surety that finances the Debtor in bankruptcy under section 364 of the Bankruptcy Code may obtain certain additional rights for the protection of the surety to give the surety adequate protection not only under section 364 of the Bankruptcy Code but also under section 363 of the Bankruptcy Code for the Debtor's use of the Contract Funds as "cash collateral." The additional protections that the surety should obtain under sections 362, 363 and 365 of the Bankruptcy Code include the Debtor's providing the surety with consensual relief from the automatic stay provisions of section 362 of the Bankruptcy Code in order for the surety to exercise the following rights:¹²⁷

- - - Authorizing the surety to exercise its rights against the Contract Funds, including the deposit of the Contract Funds to the joint control account and the use of those Contract Funds to pay bills for which the surety would be liable under its bonds;

¹²⁶ George J. Bachrach, *Financing the Principal*, in BOND DEFAULT II (Duncan L. Clore, 2d ed. 1995); Armen Shahinian and Bogda M.B. Clarke, *Anatomy of a Workout Agreement - Extension of Surety Credit to the Troubled Contractor - Financing Considerations, Strategies and Financing Agreement* (unpublished paper submitted at the Surety Claims Institute annual meeting on June 23, 1994); T. Scott Leo, *The Financing Surety and the Chapter 11 Principal*, 26 TORT & INS. L.J. 1 (1990) and (unpublished paper submitted at the American Bar Association, Forum on the Construction Industry and Tort and Insurance Practice Section, Fidelity and Surety Law Committee joint annual midwinter meeting on January 26, 1989).

¹²⁷ George J. Bachrach, *Financing the Principal*, in BOND DEFAULT II (Duncan L. Clore, 2d ed. 1995) at 160-61.

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- • Authorizing the surety to negotiate and settle all claims of subcontractors and suppliers against the payment bonds without subsequent bankruptcy court approval;
-
- • Prohibiting the Debtor from assuming or rejecting any of the underlying construction contracts without the surety's consent;
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- • Authorizing the surety to begin negotiations and discussions with obligees and other contractors concerning the potential reletting and/or completion of the bonded contracts;
-
- • Authorizing the surety to terminate any of the contracts between the obligees and the Debtor as the surety deems necessary; and
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- • Authorizing the surety to exercise any other rights and take any other actions as negotiated by the surety and the Debtor.

F. Summary.

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- Assuming that the surety can show an "interest" in the Contract Funds sufficient to make the Contract Funds fall within the definition of "cash collateral" under section 363 of the Bankruptcy Code, the surety should get the issue of the Contract Funds as "cash collateral" before the bankruptcy court by a motion to prohibit the Debtor's use of the Contract Funds, assert the surety's interest in the Contract Funds, and attempt to get satisfactory adequate protection for the Debtor's use of the Contract Funds.

IV. WHAT ABOUT THE SURETY'S NOTICE TO THE OBLIGEE TO PROTECT THE SURETY'S RIGHTS AND INTEREST IN THE CONTRACT FUNDS?

- Frequently, sureties receive notice of claims from subcontractors and suppliers who have not been paid by the principal. At some point, the surety may decide to provide written notice to the Obligee concerning the unpaid claims of subcontractors and supplies, and may demand/request that the Obligee hold onto sufficient Contract Funds for the payment of the bills of the subcontractors and suppliers and/or not pay the Contract Funds to the principal. Providing such a written notice may be a requirement in order for the surety to enforce its subrogation rights against the Contract Funds held by the Obligee.¹²⁸ Under certain circumstances, the Obligee that pays the principal the Contract Funds after written notice from the surety may be required to reimburse the surety the amounts paid to the principal after the Obligee's receipt of the surety's notice.¹²⁹

¹²⁸ Marilyn Klinger, *The Surety's Notice: What Does it Say and Does it Work?*, in SUBROGATION RIGHTS OF THE CONTRACT BOND SURETY (George J. Bachrach ed., 1990); George J. Bachrach and Robert F. Carney, *The Surety and the United States Court of Federal Claims* (unpublished paper submitted at the Surety Claims Institute annual meeting on June 22, 1995) at 40-44.

¹²⁹ The surety has successfully pursued the Obligee as a result of a wrongful payment to the principal after the Obligee's receipt of the surety's notice, and the Obligee has been required to pay a second time, this time to the surety. American Fidelity Fire Ins. Co. v. United States, 513 F.2d 1375 (Ct. Cl. 1975); Great

B. The Surety's Informational Notice.

The situation changes when the principal becomes a Debtor upon the filing of its bankruptcy proceeding. To the extent that the surety's written notice to the Obligee is an attempt to obtain possession of the Contract Funds to the exclusion of the Debtor and the Debtor's estate, or an attempt to create a lien or right against the Contract Funds, the surety may be violating the automatic stay of section 362 of the Bankruptcy Code.¹³⁰ However, not all surety notices to the Obligee rise to the level of a violation of the automatic stay. To the extent that the surety's written notice is informational only, the surety will be deemed not to have violated the automatic stay.¹³¹

American Insurance Co. v. United States, 492 F.2d 821 (Ct. Cl. 1974) (payments to principal's assignee); Fireman's Fund Ins. Co. v. United States, 421 F.2d 706 (Ct. Cl. 1970); Home Indem. Co. v. United States, 376 F.2d 890, 893-94 (Ct. Cl. 1967); National Sur. Corp. v. United States, 319 F. Supp. 45 (N.D. Ala. 1970); Home Indem. Co. v. United States, 313 F. Supp. 212 (W.D. Mo. 1970); Hanover Ins. Co. v. United States, 279 F. Supp. 851, 853 (S.D.N.Y. 1967); Transamerica Premier Insurance Company v. United States, 32 Fed. Cl. 308 (1994); Int'l Fid. Ins. Co. v. United States, 25 Cl. Ct. 469 (1992); District of Columbia v. Aetna Ins. Co., 462 A.2d 428 (D.C. App. 1983). But cf. United States Fidelity & Guar. Co. v. United States, 475 F.2d 1377 (Ct. Cl. 1973); United Pacific Insurance Co. v. United States, 362 F.2d 805 (Ct. Cl. 1966) (payment to principal was lawfully disbursed to the principal under the contract prior to any default or notice from the surety).

¹³⁰ While the surety's written notice to the Obligee may be viewed as a violation of the automatic stay of section 362 of the Bankruptcy Code, the surety's post-petition payments, which create rights for the surety against the Contract Funds, are not a violation of section 362. In re Pacific Marine Dredging and Construction, 79 B.R. 924 (Bankr. D. Or. 1987). [The court found that payment of claims post-petition by the surety as a result of bonds executed pre-petition by the surety for the debtor was not a violation of the stay under § 362(a)(4) as an act to create, perfect or enforce any lien against property of the estate. The equitable rights of subrogation of the surety relate back to the date of the bond. Therefore, the surety's lien rights were created pre-petition and not post-petition despite the post-petition payments.]

¹³¹ In In re Hughes-Bechtol, Inc., 117 B.R. 890 (Bankr. S.D. Ohio 1990), the court reviewed certain notice letters sent by the surety to certain obligees, and found that the correspondence was a "non-repetitive single mailing that was predominately informational." Id. at 906. The notice letters are attached to the court's opinion. Id. at 908-09. The language in the letters that particularly bothered the court was language that stated that the surety "believes that it will continue to have a claim against you (the obligee) for these (contract) funds if you take any action which prejudices (the surety's) rights to the funds." The court found it difficult to understand why the surety,

which appeared in numerous proceedings in this bankruptcy and filed numerous documents and requests for relief, would have failed to seek a court determination of the extent of the automatic stay prior to taking the action complained of; nevertheless, the court concludes that the mailing of the non-repetitive, predominately informational correspondence, which in this motion for summary judgment has not been demonstrated to have adversely impacted on the estate, does not constitute a violation of the automatic stay.

Id. See generally, Chad L. Schexnayder and Robert J. Berens, *The Surety on Attack in the Principal's Bankruptcy - Proven Strategies and Brave New Tactics* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual meeting on August 11, 1992) at 48-55.

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- C. The Surety's Written Notice to the Obligor to Compel the Obligor to Exercise Its Contractual Rights to the Contract Funds.
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• While there are risks to the surety in violating the automatic stay of section 362 of the Bankruptcy Code by giving the Obligor a non-informational written demand that the Obligor withhold the Contract Funds from the Debtor and/or to pay the Contract Funds to the surety, the surety may consider sending the Obligor a written notice requesting/demanding that the Obligor exercise its rights to the Contract Funds as set forth in the underlying contract between the Obligor and the Debtor. As discussed in Section IV. C. 1.(a) above, the Obligor may have certain rights to the Contract Funds pursuant to the underlying contract with the Debtor. Those contract rights may include the Obligor's right to use the remaining Contract Funds to complete the performance of the work on the contract and to pay the subcontractors, suppliers, laborers and materialmen of the Debtor who have not been paid. In In re Modular Structures, Inc.,¹³² after reviewing the terms of the contract between the obligor and the debtor, the court held that because the debtor could not satisfy the various conditions precedent in the contract, none of the contract funds in the hands of the obligor were due and owing to the debtor.

• A surety, which is subrogated to the rights of the Obligor, may consider sending written notice to the Obligor requesting or making demand that the Obligor comply with its obligations under the contract with the Debtor with respect to the payment of the Contract Funds to the Debtor. Once again, the issue arises as to whether such a written notice from the surety to the Obligor constitutes a violation of the automatic stay. Under recent non-surety case law, the surety may argue that such a written notice to the Obligor to compel the Obligor to exercise its rights under the contract against the Contract Funds may not violate the automatic stay of section 362 of the Bankruptcy Code.

• In Citizens Bank of Maryland v. Strumpf,¹³³ upon the filing of the debtor's bankruptcy proceeding, the bank placed an "administrative hold" on the debtor's bank account in an amount that would repay the bank the remaining balance of a loan made pre-petition by the bank to the debtor. The bank then filed a motion for relief from the automatic stay in order to exercise its setoff rights against the account to repay the pre-petition loan.¹³⁴

• The Supreme Court held that the bank's "administrative hold" on the account was not a setoff that violated the automatic stay.¹³⁵ The Supreme Court found that the bank, prior to the debtor's filing of its bankruptcy proceeding, had the right under Maryland law to setoff the defaulted loan against the

¹³² 27 F.3d 72 (3d Cir. 1994).

¹³³ ____ U.S. ____, 116 S. Ct. 286 (1995).

¹³⁴ Id. at 288. See also 11 U.S.C. § 362(d).

¹³⁵ Id. at 289-90. See also 11 U.S.C. § 362(a)(7).

balance in the account.¹³⁶ The bank refused to pay the balance in the account to the debtor, not permanently and absolutely, but only while the bank sought relief from the automatic stay under section 362(d) of the Bankruptcy Code. In summary, the Supreme Court allowed the bank to hold onto the funds in the account pending a determination concerning the rights of the bank to setoff the amount in the account against the pre-petition defaulted loan, and not lose its rights to the funds in the account by being required to release its “administrative hold” and allow the debtor to withdraw the funds from the account prior to a determination of the bank’s setoff rights.

- The same argument can be made for the surety’s written notice to the Obligee requesting/demanding that the Obligee exercise its rights under the contract against the Contract Funds. If the Debtor is not complying with the terms of the contract with the Obligee, the Obligee retains the right to compel the Debtor to comply with the contract terms.¹³⁷ The mere written notice from the surety alerting the Obligee to those rights and requesting/demanding that the Obligee comply with the terms of its contract with the Debtor for the surety’s protection is a situation similar to the bank’s placing an “administrative hold” on an account to protect its setoff rights. The surety is not making a demand on the Obligee to withhold payment from the Debtor or to pay the Contract Funds to the surety. Rather, the written notice alerts the Obligee that its actions or inactions may affect the rights of the surety to the prejudice of the Obligee, *i. e.*, the discharge of the surety’s obligations under the bonds, and that the Obligee must protect itself against the Debtor’s failure to comply with the terms of the contract.¹³⁸

- - D. Summary.

¹³⁶ Id. at 289.

¹³⁷ The Debtor must comply with the terms of the contract with the Obligee notwithstanding the failure of the Debtor to assume or reject the contract under section 365 of the Bankruptcy Code. See Section VII.D.1., infra.

¹³⁸ In T. Scott Leo, *Bankruptcy Considerations*, in BOND DEFAULT II (Duncan L. Clore, 2d ed. 1995).at 276, Leo states:

In obtaining control of the funds, a surety can and should notify the obligees of the bankruptcy of the principal and advise the obligees on the contracts that they should take appropriate steps to protect their rights and the surety’s rights to the contract funds. The surety might warn the obligees that the failure to take action to protect these rights might discharge the surety. The surety should also advise the obligees to seek the prompt assumption or rejection of the contract so that there is no delay and to make certain the rights of the parties to the use of contract funds are determined by the court. . . . [T]he notice should tell the obligee that it should seek adequate protection through the assumption of the contract and notify the obligee that the surety will regard the failure to take reasonable steps to assert such rights as an impairment of the surety’s rights to the contract funds and a defense to any later performance claim. Such a notice does not interfere with the debtor’s rights but merely asserts the surety’s rights against the obligee.

- Any written notice from the surety to the Obligee that prevents or delays the payment of the Contract Funds to the Debtor during its chapter 11 bankruptcy proceeding entails a risk that the bankruptcy court will find that the surety has gone too far and violated the automatic stay by attempting to exercise control over the Contract Funds. For this reason alone, the surety should consider filing a Motion to Prohibit the Debtor’s Use of Cash Collateral or some other Motion in the bankruptcy court to assert whatever rights the surety may have to the Contract Funds.¹³⁹ It is the author’s view that an informational written notice from the surety to the Obligee fails in all respects. Either the written notice is ineffective in obtaining any rights to the Contract Funds, or the written notice is effective, and the surety risks violating the automatic stay. A written notice to the Obligee requesting/demanding that the Obligee exercise its rights against the Contract Funds pursuant to the contract provisions of the Obligee’s contract with the Debtor may be much more effective and acceptable. However, if the surety truly has an “interest” in the Contract Funds, the safest and most effective route for the surety to take is the filing of a motion to prohibit the Debtor’s use of cash collateral under section 363 of the Bankruptcy Code.

v. WHAT OTHER AVENUES EXIST FOR THE SURETY TO EXPLORE TO OBTAIN RIGHTS IN THE CONTRACT FUNDS?

- There are certain other avenues that the surety may wish to explore to obtain rights in the Contract Funds. Some of the avenues have already been attempted by sureties, others have not. Regardless of the approach taken by the surety, the surety must allege that it has some rights or “interest” in the Contract Funds that compels the bankruptcy court to adequately protect the surety’s rights and interest.

B. Motion for Relief from the Automatic Stay.

- The surety may consider filing a motion for relief from the automatic stay under section 362(d) of the Bankruptcy Code for cause, including the Debtor’s lack of adequate protection of the surety’s interest in the Contract Funds.¹⁴⁰ It is the surety’s burden of proof on the issue of the cause for which it seeks relief from the automatic stay.¹⁴¹

¹³⁹ See Section VII below for other avenues for the surety to explore to obtain rights in the Contract Funds.

¹⁴⁰ See Section I.B. above.

¹⁴¹ 11 U.S.C. § 362(g)(1). In *In re RAM Construction Company, Inc.*, 32 B.R. 758 (Bankr. W.D. Pa. 1983), in order to give adequate protection to the surety, the surety was permitted to control the debtor’s use of the contract funds from the obligees and use the contract funds for the ongoing expenses for the performance of the bonded contracts. The court issued an order substantially protecting the rights of the surety in the contract funds. The court then stated:

This Order was entered for several reasons. The Court believed that the surety would not be adequately protected if the Debtor was free to pay money received from the owners for Debtor expenses on other contracts, etc. Additionally, if the Court did not fashion such protection, the Court believed the surety would request a lifting of the stay and put another contractor on the job and claim the balances owed by the owner to the

- In one reported case, the surety sought relief from the automatic stay in order to obtain control over the Contract Funds. In In re Glover Construction Co., Inc.,¹⁴² the surety attempted to terminate the stay because it perceived a lack of significant progress on the bonded contracts, thereby increasing the surety's exposure to loss. The court found that there was no cause shown to terminate the stay because:

- 2. No additional post-petition claims were generated;
 -
 3. The amount of the pre-petition claims was irrelevant;
 -
 4. Under prior rulings of the court, the surety had certain "controls" over the progress payments giving the surety adequate protection,¹⁴³ and
 -
 5. The surety failed to provide evidence of any post-petition harm to the surety that would give cause to terminate the stay, including:

- - (b) Evidence that the cost of completion post-petition was greater than the available contract funds; and

- - (c) What actions the surety intended to take to minimize its losses and make the jobs less costly if the stay was terminated in order for the surety to take over the contracts.

- Based upon the lack of existence of additional case law involving the surety seeking relief from the automatic stay in order to obtain control over the Contract Funds, such an action by the surety early on in the Debtor's bankruptcy proceeding would probably be ineffective in obtaining control over the Contract Funds.

- C. Motion to Compel the Debtor to Comply with the Provisions of the Contracts Bonded by the Surety.

- The provisions of the contract between the Obligee and the Debtor may well require the Debtor to pay its subcontractors and suppliers from the Contract Funds the Debtor receives from the Obligee. Whether there is a direct contractual obligation to make the payments, or the Debtor is contractually required to hold the Contract Funds in trust for the payment of its subcontractors and suppliers, the Debtor is obligated to ensure that its subcontractors and suppliers are paid from the Contract Funds. The surety is subrogated to the Obligee's contract rights. Therefore, even if the surety is unable to prove that it has an "interest" in the Contract

Debtor. Under the facts represented, the Court believed the surety would succeed and RAM's Chapter 11 would have a short life.

32 B.R. at 759.

¹⁴² 35 B.R. 233 (Bankr. W.D. Ky. 1983). See also Chad L. Schexnayder and Robert J. Berens, *The Surety on Attack in the Principal's Bankruptcy - Proven Strategies and Brave New Tactics* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual meeting on August 11, 1992) at 45-47.

¹⁴³ In re Glover Construction Co., 30 B.R. 873 (Bankr. W.D. Ky. 1983).

Funds for purposes of obtaining adequate protection for the Debtor's use of the Contract Funds as "cash collateral" under section 363 of the Bankruptcy Code, the surety may have standing to compel the Debtor to do what it is obligated to do under the contract bonded by the surety. At a minimum, such a Motion to Compel will bring to the bankruptcy court's attention the fact that the Debtor may be collecting Contract Funds and not using them in accordance with the terms of the contract. Since section 541 of the Bankruptcy Code does not give the Debtor's estate any greater rights in the Contract Funds than those held by the Debtor pursuant to its contract with the Obligee,¹⁴⁴ the bankruptcy court should issue an order compelling the Debtor to comply with the provisions of the contract for the use of the Contract Funds.

- To the extent that the contract bonded by the surety contains strong provisions for the Debtor's payment of its subcontractors and suppliers, and strong rights in the Obligee to require those payments by the Debtor, such a Motion to Compel can be quite effective. Where the contract between the Obligee and the Debtor is silent or weak on such rights and provisions, the surety will have a much more difficult problem. If the Debtor challenges the standing of the surety to raise such a Motion to Compel, the surety may allege that it is acting as a party interest in its own right as surety as well as enforcing the rights of the subcontractors and suppliers to the Debtor.

- D. Motion to Compel the Debtor to Comply with its State or Federal

- Statutory Obligations to the Obligee and the Claimants.

- As described previously in this paper, the Debtor may have state statutory trust fund obligations to the Claimants,¹⁴⁵ other statutory obligations to pay the Claimants,¹⁴⁶ or other state statutory or federal statutory obligations to the Obligee or the Claimants to which the surety may be subrogated. Even if the surety is unable to prove that such a subrogated interest is an "interest" in the Contract Funds for purposes of obtaining adequate protection for the Debtor's use of the Contract Funds as "cash collateral" under section 363 of the Bankruptcy Code, the surety may have standing, as a party in interest, to compel the Debtor to do what the Debtor is obligated to do under its state or federal statutory obligations. The possibilities for a surety under the state statutory rights in the various states and under federal law are potentially enormous. The surety should file a Motion to Compel the Debtor to comply with its state and federal statutory obligations for the protection of the Obligee, the Claimants and the surety. Once again, at a minimum, such a Motion to Compel will bring to the bankruptcy court's attention the fact that the Debtor may be collecting Contract Funds and not using them in accordance with the state and federal statutory obligations of the Debtor.

- E. Motion by the Surety to Compel the Debtor to Accept or

- Reject the Executory Construction Contract Within a Specific

- Period of Time - Sections 365 and 105 of the Bankruptcy Code.

- 2. Executory Contracts - Section 365 of the Bankruptcy Code.

¹⁴⁴ See supra note 22.

¹⁴⁵ See Section IV.C. 2. (c).

¹⁴⁶ See Section IV.C. 2. (d).

- Section 365 of the Bankruptcy Code provides that the Debtor, subject to the bankruptcy court's approval, may assume or reject any executory contract.¹⁴⁷ The Bankruptcy Code does not define the term "executory contract." However, many bankruptcy courts have adopted the "Countryman definition," according to which a contract is executory if the obligations of both the Debtor and the non-debtor party remain so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other.¹⁴⁸ In the construction contract setting, where the Debtor is continuing to perform the construction contract and the non-debtor party, the Obligee, is continuing to pay the Debtor for its performance, the construction contract would be an executory contract.¹⁴⁹

- Normally, a Debtor filing a chapter 11 bankruptcy proceeding would want to continue with its profitable executory contracts. However, if there has been a default in an executory contract, *i. e.*, the failure of the Debtor to pay its subcontractors and suppliers, the Debtor may not assume that contract unless, at the time of assumption of the contract, the Debtor:

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¹⁴⁷ Marc I. Fenton, *Executory Contracts and the Role of the Surety* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual meeting on August 10, 1993); J. Michael Franks and John H. Rowland, *Surety Strategy in the Chapter 11 Proceeding: Case Study of a Broke Contractor* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual meeting on August 10, 1993); Chad L. Schexnayder and Robert J. Berens, *The Surety on Attack in the Principal's Bankruptcy - Proven Strategies and Brave New Tactics* (unpublished paper submitted at the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee annual meeting on August 11, 1992); John V. Burch, *Pre-Bankruptcy Agreement to Abandon an Executory Construction Contract - A New Tool for the Surety* (unpublished paper submitted at the Third Annual Southern Surety and Fidelity Claims Conference on May 7, 1992).

¹⁴⁸ Adopting the "Countryman definition": Sharon Steel Corp. v. National Fuel Gas Distribution Corp., 872 F.2d 36, 39 (3rd Cir. 1989); Gloria Mfg. Corp. v. International Ladies' Garment Workers' Union, 734 F.2d 1020, 1021-1022 (4th Cir. 1984); In re Snowcrest Development Group, Inc., 200 B.R. 473, 477 (Bankr. D. Mass. 1996); In re Child World, Inc., 147 B.R. 847, 851 (Bankr. S.D.N.Y. 1992). Adopting a "functional" approach in which the "executoriness" of the contract is determined by whether assuming or rejecting would produce the benefit to the bankruptcy estate: In re General Development Corp., 177 B.R. 1000 (S.D. Fla. 1995), *aff'd.* 84 F.3d 1364, 1375 (11th Cir. 1996); In re Drexel Burnham Lambert Group, Inc., 138 B.R. 687, 697 (Bankr. S.D.N.Y. 1992).

¹⁴⁹ A number of authors have questioned whether the surety's performance and payment bonds are executory contracts that may be assumed or rejected by the Debtor, or whether they are deemed to be "financial accommodations" that may not be assumed by the Debtor. 11 U.S.C. § 365(c)(2). T. Scott Leo, *Bankruptcy Considerations*, in BOND DEFAULT II (Duncan L. Clore, 2d ed. 1995) at 286-89; T. Scott Leo and Gary A. Wilson, *Suretyship and the Bankruptcy Code*, in THE LAW OF SURETYSHIP 9-1 (Edward G. Gallagher ed., 1993) at 9-9 to 9-12. There is little question that the bonds are "financial accommodations." In re Sun Runner Marine, Inc., 945 F.2d 1089 (9th Cir. 1991); In re Edward's Mobile Home Sales, Inc., 119 B.R. 857 (Bankr. N.D. Fla. 1990); In re Adana Mortgage Bankers, Inc., 12 B.R. 977 (Bankr. N.D. Ga. 1980); In re Wegner Farms, 49 B.R. 440 (Bankr. N.D. Iowa 1985). However, there is a question concerning whether the bonds are "executory contracts." Any further discussion of this fascinating issue is beyond the scope of this paper .

- (1) cures, or provides adequate assurance that the trustee will promptly cure, such default;
-
- (2) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
-
- (3) provides adequate assurance of future performance under such contract or lease.¹⁵⁰

• Under section 365(d), in a case under chapter 7 of the Bankruptcy Code, the contract is deemed rejected if the Trustee does not assume the contract within 60 days from the date of the order for relief, or for such additional time as may be granted by the bankruptcy court for cause.¹⁵¹ In contrast, in a case under chapter 11 of the Bankruptcy Code, the Debtor may assume or reject an executory contract at any time before the confirmation of the plan of reorganization; however the bankruptcy court, on the request of any party to the contract, may order the Debtor to determine within a specified period of time whether to assume or reject the contract.¹⁵²

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3. Power of Court - Section 105 of the Bankruptcy Code.

• Notwithstanding the provisions of section 365 of the Bankruptcy Code, section 105 of the Bankruptcy Code defines the general powers of the bankruptcy court to issue any order, process or judgment that is necessary or appropriate to carry out the provisions of the Bankruptcy Code.¹⁵³ On its own motion or upon the request of a party in interest, the bankruptcy court may hold a status conference regarding any case or proceeding, and issue an order to ensure that the case is handled expeditiously and economically, including an order that sets a date by which the Debtor must assume or reject an executory contract.¹⁵⁴ Therefore, the surety, while not a party to the contract between the Obligee and the Debtor under section 365 of the Bankruptcy Code, is a party in interest in the bankruptcy proceeding, and may request an order pursuant to section 105 of the Bankruptcy Code that the bankruptcy court compel the Debtor to assume or reject an executory construction contract within a specified period of time.

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4. Summary.

¹⁵⁰ 11 U.S.C. § 365(b)(1)(A) - (C).

¹⁵¹ 11 U.S.C. § 365(d)(1).

¹⁵² 11 U.S.C. § 365(d)(2). There is a question as to whether the surety is a party to the construction contract such that it may request that the Debtor make its determination within a specified period of time.

¹⁵³ 11 U.S.C. § 105(a).

¹⁵⁴ 11 U.S.C. § 105(d)(2)(A).

- A surety's attempts to obtain rights in the Contract Funds by requiring the Debtor to assume or reject the executory construction contract can be very frustrating and time consuming. Because the Debtor does not have to formally make a decision as to whether to assume or reject a construction contract until just before the confirmation of its plan of reorganization, most Debtors keep "performing" the work and "collecting" payments of the Contract Funds. There is no impetus for the Debtor to assume or reject an executory construction contract early on in the bankruptcy proceeding. Furthermore, by the date of confirmation, the contract may well be completed. Therefore, in order to force the Debtor to make a decision, the Obligee, as a party to the construction contract with the Debtor, must take action under section 365(d)(2) of the Bankruptcy Code, or the surety must move in accordance with section 105 of the Bankruptcy Code to set the time requirements for the Debtor to make a decision.

- A Debtor will normally have problems in assuming an executory construction contract because the Debtor must cure any defaults, including any defaults in payment to subcontractors and suppliers, and must provide adequate assurance of future performance.¹⁵⁵ If these burdens are not met by the Debtor, the construction contract must be rejected. If the construction contract is rejected, the Obligee may treat the rejection as a termination and make demand upon the surety to perform under the performance bond.¹⁵⁶ At the time of rejection, the Obligee should not be making any further payments of the Contract Funds to the Debtor or the Trustee, and they should eventually be available to the surety.¹⁵⁷

SUMMARY AND CONCLUSION.

A long time ago when this paper started, it was suggested that the surety must educate the bankruptcy court concerning its rights and interests in the Contract Funds, and adapt to the

¹⁵⁵ 11 U.S.C. § 365(b)(1).

¹⁵⁶ While this result may be the effective result of the Debtor's rejection of the construction contract, the Bankruptcy Code is not clear concerning whether a rejection of an executory contract is a termination. Section 365(g) states that the rejection of an executory contract constitutes a breach of such contract immediately before the date of the filing of the bankruptcy petition (unless the construction contract has already been assumed during the chapter 11 bankruptcy proceeding, something which rarely occurs with a construction contract). Question: Does a breach of the construction contract equal a termination of the construction contract? Some surety practitioners argue that the only way for an Obligee to terminate the construction contract is to file a motion seeking relief from the automatic stay under section 362(d) of the Bankruptcy Code in order to exercise the Obligee's contractual rights to terminate the Debtor's performance under the contract. T. Scott Leo, *Bankruptcy Considerations, in* BOND DEFAULT II (Duncan L. Clore, 2d ed. 1995) at 251, note 3.

An order addressing the assumption and rejection of executory contracts ought to expressly provide that the automatic stay is lifted with respect to any rejected contracts to permit their termination and to enable the surety to take the necessary steps to cure defaults and arrange for completion.

Id. at 284.

¹⁵⁷ In In re FLR Co., 58 B.R. 632 (Bankr. W.D. Pa. 1985), the court found that the debtor's proposed use of the contract funds without assumption of the underlying contract did not provide adequate protection to the owner, and prohibited the debtor's use of the contract funds. If the Debtor is not allowed to use the Contract Funds without assuming the contract, the Obligee should not be paying the Debtor any of the Contract Funds when the contract has been rejected.

practice in the bankruptcy courts to assert its substantive rights and negotiate the best deal possible. Because the surety's rights to the Contract Funds are substantial but not crystal clear, the surety should immediately negotiate with the Debtor and its counsel for whatever protections the surety deems adequate for the Debtor's use of the Contract Funds. If the Debtor will not cooperate, or other parties in interest, such as the bank, refuse to acknowledge the surety's rights and interests, the surety should immediately file its motion to prohibit the Debtor's use of cash collateral. The surety should also consider taking other steps, including providing notice to the Obligee and to the Debtor concerning their respective obligations with respect to the Contract Funds under the terms of the contract and any state statutes. The surety may have to go to the bankruptcy court to compel the Debtor to comply with its obligations under the contracts with respect to the Contract Funds. As stated above, there may be other avenues which exist for the surety to protect its rights in the Contract Funds.

What the surety should not do is to sit on its hands and do nothing. While the automatic stay may prohibit some actions that the surety may want to take, there are actions that the surety may explore to ensure that the bargain negotiated at the time of the execution of the bonds - namely, the use of the Contract Funds for the payment of the performance of the work and the bills of the subcontractors and suppliers - is maintained during the Debtor's ongoing bankruptcy proceeding.

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