

**ELEVENTH ANNUAL  
NORTHEAST SURETY AND FIDELITY CLAIMS  
CONFERENCE**

***“Financing the Principal”* - Panel Discussion**  
**(including an analysis of the circumstances under which a surety would consider financing a principal, the information to be gathered, the advantages and disadvantages of financing, a review of the character,**

**Moderated By:**

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# **FINANCING THE PRINCIPAL\***

by

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## **I. INTRODUCTION**

The goal of any surety handling a claim is to perform the surety's obligations under its bonds in a fair, efficient and economical manner. When faced with a claim against its performance bond, one of the surety's alternatives is to finance the principal. The surety's objective in financing the principal is to remedy a potential or existing default under the construction contract, and to avoid a termination of the principal's right to proceed under the bonded contract.<sup>1</sup>

Financing can be defined as the surety providing direct or indirect financial assistance to the principal in the hope that the contract obligations secured by the performance bond will be completed by the principal. As described below in this paper, the surety's direct or indirect financial assistance can take several forms.

This paper concerning the financing of the principal as a means of handling a claim against the surety's performance bond will address a number of issues, including: the information and analysis necessary prior to financing the principal; the methods of financing the principal; the surety's right to finance the principal; the advantages and disadvantages in financing the principal as opposed to other completion options; financing the subcontractor principal; the procedures and mechanics for financing the principal; financing the principal in bankruptcy; the risks to the surety beyond the penal sum of its performance bond; and the subrogation rights of the performance bond surety financing the principal.

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\* This paper is an updated version of the materials that I prepared for Chapter 4 of the Bond Default Manual, 2nd Ed. (Duncan L. Clore ed., 1995) entitled "Financing the Principal," a publication of the American Bar Association, Tort and Insurance Practice Section, Fidelity and Surety Law Committee. The chapters in the Bond Default Manual, 2nd Ed., include chapters on: bonds, contractual and statutory provisions and the general agreement of indemnity; the surety's investigation; the surety's analysis of the results of the investigation; financing the principal; takeover and completion; tender; completion by the bond obligee; public works projects; bankruptcy considerations; extra-contractual damages considerations; considerations with respect to other insurance coverage; ethical considerations' and salvage/subrogation considerations. The Bond Default Manual, 2nd Ed. may be purchased through the Tort and Insurance Practice Section of the American Bar Association.

<sup>1</sup> This paper will not attempt to subjectively analyze the surety's alternative of financing the principal as a means of handling performance bond claims. However, other commentators have been willing to express their views. For example, one set of commentators have described financing the principal as "the most controversial and most maligned of the completion options available to the performance bond surety. This is because financing is not a panacea but a danger-filled mine field which can lead to disaster...In deciding whether to finance, the surety's natural prejudice should be not to take this step. This prejudice occurs because the arguments in favor of financing are much more persuasive and compelling in theory than they are in practice." Bond Default Manual, Chapter 2 (R. Wisner ed., 1987) entitled "Financing the Contractor" by Thomas A. Joyce and William F. Haug at p. 21 (hereinafter referred to as Joyce and Haug). Another commentator has stated that "[f]inancing is always a potentially dangerous course of action." Schroeder, Gilbert J., "Procedures and Instruments Utilized to Protect the Surety Who Finances a Contractor." 14 Forum 830, 868 (1979) (hereinafter referred to as Schroeder No. 1). "Financing is dangerous." Schroeder, Gilbert J., "Providing Financial Support to the Contractor." 17 Forum 1190, 1205 (1982) (hereinafter referred to as Schroeder No. 2). Several additional and more recent papers and articles have been written on the subject, including: The Law of Suretyship, 2nd Ed., Chapter 6 (Edward G. Gallagher ed., 2000) entitled "Contract Performance Bonds" by Marilyn Klinger, James P. Diwik and Kevin L. Lybeck; The Law of Performance Bonds, Chapter 3, (Lawrence R. Moelmann and John T. Harris eds, 2000) entitled "Rights of Surety in Event of Default" by James J. Mercier and John T. Harris; Seminara, Nicholas and Sheehey, Christopher, Jr., "The Surety's Guide to Financing: Point Counterpoint," an unpublished article presented to the Fidelity and Surety Law Committee of the Tort and Insurance Practice Section of the American Bar Association on January 22, 1999; Haug, William F., "Financing Your 'Solvent' Principal-Success or Failure," an unpublished article presented to the Fidelity and Surety Law Committee of the Tort and Insurance Practice Section of the American Bar Association on January 26, 1996.

## **II. OVERVIEW - INFORMATION AND ANALYSIS NECESSARY PRIOR TO THE SURETY'S FINANCING THE PRINCIPAL**

Chapters 2 and 3 of The Bond Default Manual, 2nd Ed.<sup>2</sup> go into great detail concerning the information that must be gathered during the surety's investigation when there is a performance bond default, and the analysis the surety must perform prior to deciding how to fulfill its performance bond obligations. During the initial underwriting process and prior to executing bonds on behalf of the principal, the surety reviews the three "C's" - the cash, capacity and character of the principal. When faced with the decision on whether to finance the principal, the surety must review and analyze the information collected during the investigation process, and revisit the three "C's" along with a fourth "C" - the collateral of the principal and the indemnitors that may be available to reduce the surety's actual or potential loss.

### **A. Cash**

#### **1. How Much?**

It is obvious when a principal seeks financing from the surety that the principal lacks sufficient cash to continue the performance of the work and to pay all bills of laborers and materialmen on the bonded contracts. During the surety's investigation and analysis of the information collected, the surety will learn how much cash the principal has. More importantly, the surety will learn how much more cash the principal needs to pay current bills on the bonded contracts, to replace payments from obligees that may be delayed because of disputes with the obligees, real or otherwise, to replace payments the principal received from the obligees and used on other contracts, bonded or nonbonded, and to fund overhead items required to maintain the principal in business. Furthermore, the analysis must be extended to estimate the principal's cash requirements in the future.<sup>3</sup>

#### **2. Other Sources of Cash**

While an analysis of the contract funds from the bonded contracts is critical, there may be other sources of cash. The principal may have lines of credit on which to draw. The principal may have receivables from nonbonded contracts (i.e., contract balances, retainages

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<sup>2</sup> Chapter 2 of the Bond Default Manual, 2nd Ed. concerns the surety's investigation in order to help the surety decide how to address a performance bond default. Chapter 2 discusses the objectives of the investigation, the surety's initial response, the surety's duty to conduct an independent investigation, the sources of information the surety will review in making its decision, and how the surety protects its salvage rights. Chapter 2 also discusses the surety's use of consultants and their role in a performance bond default. Chapter 3 of the Bond Default Manual, 2nd Ed. is a detailed analysis of the results of the surety's investigation and whether the surety has a duty or obligation to perform under its performance bond. Chapter 3 reviews various types of performance bonds, whether there is a default by the principal under the construction contract, the obligee's rights under the construction contract and the performance bond, and whether the surety has any defenses to the performance bond claim prior to making a determination concerning how to perform under the performance bond.

<sup>3</sup> One question that always arises during the surety's initial investigation, but which rarely can be answered until much later, if at all, is where the cash went. Assuming that the principal's bids on the bonded contracts were within an acceptable range for the surety to write the final performance bonds, in theory there should be sufficient cash to complete the performance of the work and to pay all bills of laborers and materialmen on the bonded contracts. Since it is the surety's primary objective to fulfill its obligations under the performance bonds, an investigation to answer the question of where the cash went must be left to a later date. Except under rare circumstances, the surety will not incur the costs for such an investigation unless it may lead to substantial salvage recoveries. Even if it is obvious that the cash has disappeared under suspicious circumstances, this may or may not affect the surety's decision on whether to finance the principal.

and claims) that may be used to pay certain bills, including overhead items. The principal may have real and personal property (i.e., excess equipment) that may be sold to generate additional cash over time. The indemnitors may have cash or assets that can be converted to cash to fund the principal. Unfortunately, the assets of the indemnitors are frequently less liquid (i.e., real property) and may not be readily converted to cash in the time frame necessary to keep the principal functioning. Finally, depending upon the circumstances, banks or other lenders, with or without the surety's guarantee, may be willing to lend funds to the principal.

## **B. Capacity of the Principal to Perform the Work**

The principal needs financing when it lacks the cash to meet the costs incurred and to be incurred to perform the work on the bonded contracts. The surety can provide that cash to the principal in a number of ways. The surety cannot to any meaningful extent improve the principal's capacity to perform the work. Prior to considering financing the principal, the surety must assure itself that the principal is capable in performing the work in the following three areas:

### **1. Technical Ability to Perform the Work**

The surety must be confident that the principal has the manpower and the field construction and home office expertise to perform the work on the bonded contracts. For example:

(a) Manpower - The surety must believe that the principal can secure the necessary manpower, both in quality and quantity, to perform the work timely;

(b) Technical Ability and Construction Expertise - The surety must believe that the principal's project managers, supervisors, foremen, etc. know what they are doing and have the technical construction expertise to perform and complete the work on the bonded contracts; and

(c) Home Office Expertise - The surety must believe that the backup services at the principal's home office (i.e., accounting expertise, record keeping, etc.) are sufficient and accurate in order to ensure that the principal's progress in performing the work can be measured and computed.

The key factors are whether the work performed by the principal is of sufficient quantity to move the bonded contracts forward timely and of sufficient quality that it will be accepted by the obligees.

### **2. Ability to Manage the Work and Supervise the Subcontractors**

Along with the technical ability to perform the work, the surety must believe that the principal has the managerial competence and organization, both in the field and in the home office, to manage the work and supervise the subcontractors. The surety must review the relationships between the principal and the obligees and between the principal and its subcontractors and suppliers. If these relationships are in bad shape, the principal's performance of the work may take more time and be more expensive. If the work being

performed is not managed properly in a competent, coherent and organized manner, financing the principal may not obtain the objectives that the surety wants to reach.

### 3. Ability to Close Out the Bonded Projects

The biggest drain increasing the surety's loss may well rest on the principal's historic ability to close out the bonded contracts. The principal's inability to substantially complete the work and close out the bonded contracts will extend the time and cost of financing the principal's overhead and general administrative expenses. Increased time equals an increase in the surety's loss.

## **C. Character of the Principal and the Indemnitors**

The character of the principal and the indemnitors, including their honesty, integrity, trustworthiness and commitment to completing the work on the bonded contracts, is critical. Financing the principal is rarely a short term endeavor, especially when there are multiple bonded contracts to complete. Surety financing requires constant contact with the principal, at least on a weekly basis. Numerous issues arise, including disputes with obligees, subcontractors and suppliers, discussions concerning overhead expenses that the principal maintains must be paid, etc. The surety must believe that the principal and the indemnitors are putting forth their best efforts to complete the work on the bonded contracts, providing ready access to their books, records and other necessary information, and attempting to minimize the surety's loss. This does not mean that the principal and the surety will agree on everything. Rather, it means that the surety must have confidence that the principal is trying its best to provide prompt and accurate information and answers to the surety's questions. This is true whether the principal is determined to stay in business in some fashion or acknowledges a wind down situation ultimately resulting in the cessation of the principal's operations.

If, in the opinion of the surety, the principal and the indemnitors lack the honesty, integrity, character and trustworthiness that is so necessary for a successful financing arrangement, then the surety should immediately stop its consideration of financing the principal.

## **D. Collateral - The Big Seducer**

There are many times when the surety views financing the principal as a viable option, not necessarily because of the capacity or character of the principal and the indemnitors, but because the principal and/or the indemnitors may have collateral security to reduce or eliminate the surety's loss. The surety should be very careful about the seductive qualities that exist when collateral security appears to be available.

The assets and, therefore, the potential collateral security of the principal and the indemnitors are a factor during the underwriting process. However, the underwriting assumption is that the contract funds coming from the bonded contracts should be sufficient to pay the bills incurred on the bonded contracts as well as providing for the payment of the principal's overhead and profit. The importance of cash, and therefore liquidity in the principal, arises because payments from the bonded contracts normally lag behind the principal's practical obligation of funding the construction process. Assuming that the principal has cash,

capacity and character acceptable to the surety, bonds will be executed for the principal without the surety taking collateral security from either the principal or the indemnitors at the time of the execution of the bonds.<sup>4</sup>

The existence of assets to provide collateral security to the surety raises two issues. The first issue is whether the existence of the collateral security is a factor, in and of itself, in the surety's making the decision to finance the principal. The second issue is how to secure the collateral security in the event that the surety has or will incur a loss.

## 1. Making the Decision

Assuming that the principal has the capacity to perform the work on the bonded contracts and the character to merit the surety's financial support, the existence of sufficient assets to provide collateral security to the surety to reduce or eliminate the surety's actual or potential loss becomes a big factor. By taking the collateral security, the surety may not have to initiate an indemnity or exoneration action against the principal and the indemnitors. This avoids an immediate adversarial situation with the principal and the indemnitors, saving the surety time, expense and energy, and allowing the surety to focus on resolving its performance bond obligations. Furthermore, if losses are incurred, the surety has a readily available source of salvage for those losses. Finally, because the surety is not required to finance the principal, surety financing should be considered to be new value given to the principal and the indemnitors that will allow the liens on the collateral security to remain in effect in the event that the principal and/or the indemnitors subsequently file bankruptcy proceedings. Providing financing in return for collateral security contemporaneously obtained should not be deemed to be a preference under section 547 of the Bankruptcy Code<sup>5</sup> or a fraudulent conveyance under section 548 of the Bankruptcy Code.<sup>6</sup>

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<sup>4</sup> Many sureties in many markets require the principal and the indemnitors to provide collateral security at the time the bonds are first executed. Such a surety may be in a different position when determining whether to finance the principal to reduce its loss. Since the surety already has collateral security, there may be no additional incentive to finance the principal. Furthermore, the surety has a cushion against its loss and may be better able to define its loss through another performance bond option rather than a potential open-ended financing arrangement with the principal. This paper will assume that no collateral security has been taken by the surety prior to the time that the principal finds itself in financial difficulties and needs financial assistance from the surety.

<sup>5</sup> 11 U.S.C. § 547. See The Law of Suretyship, 2nd Ed., Chapter 20 (Edward G. Gallagher ed., 2000) entitled "Bankruptcy and the Surety" by Chad L. Schexnayder; The Law of Performance Bonds, Chapter 12 (Lawrence R. Moelmann and John T. Harris eds., 2000) entitled "Bankruptcy" by Chad L. Schexnayder; Shahinian, Armen and Clarke, Bogda, M.B., "Anatomy of a Workout Agreement - Extension of Surety Credit to the Troubled Contractor - Financing Considerations, Strategies and Financing Agreement," an unpublished article presented to the Surety Claims Institute, Absecon, N.J., June 23, 1994 (hereinafter referred to as Shahinian and Clarke); Berens, Robert J., "Bankruptcy: Can a Surety be Held Liable for the Prepetition Payments Made by its Principal?", an unpublished article presented to the Fidelity and Surety Law Committee of the Tort and Insurance Practice Section of the American Bar Association on August 10, 1993; Franks, J. Michael and Rowland, John J., "Surety Strategy in the Chapter 11 Proceeding: Case Study of a Broke Contractor," an unpublished article presented to the Fidelity and Surety Law Committee of the Tort and Insurance Practice Section of the American Bar Association on August 10, 1993; The Law of Suretyship, Chapter 9 (Edward G. Gallagher ed., 1993) entitled "Suretyship and the Bankruptcy Code" by T. Scott Leo and Gary A. Wilson.; Leo, T. Scott, "The Financing Surety and the Chapter 11 Principal," 26 Tort and Insurance Law Journal 45 (1990) (hereinafter referred to as Leo).

<sup>6</sup> 11 U.S.C. § 548.

## 2. Obtaining the Collateral Security

Early in its investigation, the surety should obtain information from the principal, the indemnitors and other sources concerning the assets of the principal and the indemnitors, including the present lien status (consensual liens, judgment liens, tax liens, etc.) and the value of the assets to the extent that such information exists. Contemporaneous with the execution of the financing agreement and the initial providing of financing, the liens on the collateral security should be secured by the appropriate mortgages and deeds of trust on real estate, and perfected security interests and filed financing statements on personal property.

Two questions that frequently arise with respect to collateral security taken by the surety are:

(a) When can or should the collateral security be sold by the principal and the indemnitors, or the surety as a lien or secured creditor, to reduce or eliminate the surety's loss? The simple answer is immediately. If that is not practical or possible, it is important to have an orderly and planned liquidation if sales of collateral security are necessary to reimburse the surety. How and when the sales occur should be discussed with the principal and the indemnitors at the time of the execution of the financing agreement.<sup>7</sup>

(b) Where do the proceeds of sale go? Certainly the proceeds of sale of the collateral security, after costs of sale and prior liens are paid, should go to the surety in some fashion. The surety should not release its lien until it has control of the proceeds of sale. Whether the proceeds are "reinvested in the principal" to avoid the surety having to put more of its own money into the principal, or whether the proceeds are used to reduce the loss already incurred by the surety is a decision that must be made under the particular circumstances of each case.

While collateral security given to the surety is an option when assets of sufficient value exist, there are other ways that the surety may benefit from the existence of collateral security without the surety actually taking a lien on the assets. These include:

(a) Guaranteed Bank Loan.<sup>8</sup> The surety may work with the principal's bank to provide the collateral security to the bank in return for a loan from the bank to the principal. With the principal being in financial difficulties, the surety may have to guarantee the bank loan for the principal. However, banks may be more familiar in dealing with issues of collateral security, including foreclosures on real estate and auction sales of personal property. The bank may be more willing than the surety to take the collateral security. A surety guarantee is normally required in the event the collateral security does not bring sale proceeds sufficient for the bank to be repaid in full.<sup>9</sup>

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<sup>7</sup> See also Section VII.E. of this paper for a discussion of various provisions contained in the Financing and Collateral Agreement concerning the sale and liquidation of the collateral security.

<sup>8</sup> See also Section III.B. of this paper.

<sup>9</sup> The ideal situation is to have the bank agree to foreclose on part or all of the collateral security before it calls on the surety's guarantee. If the bank does foreclose, it should give notice to the surety. If the surety is required to pay first under its guarantee, the bank should assign its remaining interest in the collateral security to the surety.

(b) Immediate Sale of Collateral. Rather than taking a lien on the collateral security, the surety may require the principal and the indemnitors to immediately liquidate the collateral security and use the proceeds of the liquidation to fund the principal rather than using the surety's money. This method is available if the principal or the indemnitors have marketable securities, cash in bank accounts or money market funds, certificates of deposit, and/or other more liquid assets. Under most agreements of indemnity, the principal and the indemnitors are required to exonerate the surety prior to the surety spending its own funds. If the collateral security is liquid and can be timely invested in the principal's operations, the surety should require liquidation so that the surety does not have to use its own funds or decide at a later date when and if to liquidate the collateral security it holds. If the collateral security is illiquid, such as stock in a closely held corporation, real estate or equipment, it may not be feasible to have a sale that will produce proceeds quick enough to invest in the principal to reduce or eliminate the principal's financial difficulties.

The final issue with respect to using real estate as collateral security is the possible existence of hazardous wastes on the real estate "controlled" by the surety, which could potentially expose the surety to liability under various state and federal statutes.<sup>10</sup>

## **E. Summary**

The surety's analysis of the information provided by the principal and the indemnitors during the investigation will probably conclude that the principal lacks sufficient cash to complete the bonded contracts. Therefore, the principal's capacity to perform the work and the character of the principal and the indemnitors in their commitment to indemnify and hold harmless the surety become critical. If either of those two factors do not exist to the surety's satisfaction, financing the principal is not a viable option in handling the performance bond claims. The existence of collateral security can be a factor, but collateral security only reimburses the surety for its loss. It does not complete the work on the bonded contracts. Furthermore, the value of that collateral security can decrease over time, both as a result of market factors and because of the surety's "investments" in the collateral security (mortgage payments, taxes, upkeep, etc.). Generally, for the surety to consider financing the principal as a performance bond option, the surety must have reached the conclusion that there is nothing wrong with the principal that money cannot cure, and that the other conditions - capacity, character and collateral - appear favorable.

## **III. THE METHODS OF FINANCING THE PRINCIPAL**

There are a number of methods for the surety to provide financial assistance to the principal. Some of the methods are more direct than others. During any method of financing, the surety must be assured that the contract funds collected from the bonded contracts in the future will be used by the principal to complete the performance of the work and to pay the bills on the bonded contracts. Therefore, the surety should require a joint control trust account for the collection of the contract funds from the bonded contracts and joint control over the use of those contract funds in the future. The direct and indirect methods for the surety to provide financial assistance to the principal include the following.

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<sup>10</sup> See Section IX.D. of this paper.

## **A. Advancing or Lending Money to the Principal**

Advancing or lending money directly to the principal is the most obvious method for a surety financing the principal. Initially, the surety may immediately pay the principal's payroll and certain key subcontractors and suppliers for a short period of time to maintain the status quo during the surety's investigation. This "look-see" financing keeps the bonded contracts moving, thereby giving the surety time to perform its investigation (to "look") and determine its course of action (to "see" what the surety wants to do).<sup>11</sup> The surety's decision may be the financing of the principal on some or all of the bonded contracts. Much of the remainder of this paper will discuss the right of the surety to advance or loan monies to the principal and the procedures and mechanics for accomplishing the surety's direct financial assistance to the principal.

## **B. Guaranteed Bank Loan**

Rather than directly advancing or lending money to the principal, the surety may guarantee a bank loan or other debt resulting in monies being made available to the principal from third parties.

Guaranteeing a bank loan will usually be used only when there is a realistic possibility that the contractor will be able to pay it off. It normally doesn't make sense to guarantee a bank loan and incur the interest and financing charges unless you expect these expenses to be borne by the principal.

There are, however, two situations in which it may be wise to accept this burden. One is where the contractor is broke, but he does have some assets, and he does want to complete the work. In a situation such as this, have him pledge his assets to the bank rather than to the surety. The pledging of the assets to the bank in consideration for the bank loan should shelter the assets from attack as voidable preference under the Bankruptcy Act.

The second situation involves federal contracts. The government does not recognize assignments to sureties. It only recognizes assignments to financial institutions. In addition, it is possible that the Assignments of Claims Act may prevent the United States from offsetting against the contract fund.<sup>12</sup>

When the principal and the indemnitors have assets with which to provide collateral security to the surety, the surety may determine it is best to have the collateral security

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<sup>11</sup> The commentators recommend that the principal and the indemnitors be advised both verbally and in writing that such "look-see" financing "is a temporary means to give the surety time to complete its investigation and in no way commits the surety towards financing or any other course of action." Joyce and Haug, supra, note 1 at p. 22. A draft of a written notice letter is attached as Appendix B to this paper at p. B-1. Copies of the letter should be signed by the principal and the indemnitors.

<sup>12</sup> Joyce and Haug, supra, note 1 at p. 31.

provided to a bank instead in order for the principal to obtain a bank loan guaranteed by the surety.<sup>13</sup> The surety may never have to pay on the guarantee and incur a resulting loss.

### **C. “Back Door Financing”**

There are many times when a principal requires financial assistance because its cash flow cannot meet the payment of its bills on the bonded contracts on a current basis. Every month, the principal scrambles to scrape up enough cash to keep the bonded contracts moving, but can never seem to get over the hump. The bonded contracts slow down when the subcontractors and suppliers perceive that they will not be paid on a timely basis. While this appears to be a payment bond problem, the principal’s slowdown in the performance of the work on the bonded contracts may lead to performance bond claims against the surety if the obligees determine that the principal may be in default under the terms of the construction contracts and consider the termination of the principal. The obligees may also attempt to withhold liquidated damages from progress payments, thereby further increasing the principal’s cash flow problems.

If the surety pays certain bills on the bonded contracts, thereby bringing the subcontractors and suppliers current, the principal benefits in two ways:

1. The subcontractors and suppliers are less likely to drag their feet and slow down the progress of the work on the bonded contracts; and
2. By catching up and becoming current with its payments to the subcontractors and suppliers, the principal may use future contract funds earned on the bonded contracts on a monthly basis to complete the performance of the work and to pay the bills of the subcontractors and suppliers as they are paid.

This concept of “indirectly” financing the principal is frequently known as “back door financing.” The surety’s major risk in providing “back door financing” to the principal is that the principal becomes “healthy” on a current basis, and could become less cooperative in the future with respect to providing collateral security to the surety. The surety should make it very clear to the principal and the indemnitors that they are liable to indemnify the surety for the “back door financing,”<sup>14</sup> and should attempt to obtain collateral security immediately for its payments.

### **D. Providing Additional Bonds to the Principal**

Another method of “indirect financing” is for the surety to provide additional bonding credit to the principal in an effort to rehabilitate the principal. The strategy is that the principal can solve its problems if additional work and additional contract funds become available over time. This may work if the principal has several claims against obligees that have not been resolved, thereby affecting the principal’s cash flow and balance sheet. The surety must be extremely selective in this method of financing the principal for the following reasons:

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<sup>13</sup> See also Section II.D.2 of this paper; Schroeder No. 1, supra, note 1 at p. 834-36 and p. 843.

<sup>14</sup> See note 11, supra, and Appendix B to this paper. The same type of letter should be sent to and signed by the principal and the indemnitors.

1. Providing additional bonds does not cure the initial problem of a lack of cash to complete the performance of the existing work and to pay current bills on the bonded contracts. The lag time from bid to award to payment of the first requisition (after the principal has expended monies for the bonds, mobilization, etc.) will not provide cash on a timely basis. To the extent that the principal and the indemnitors can provide their own cash to the principal, rather than the surety, this lag time might not be such of a great concern;

2. Providing additional bonds that produce immediate new work to the principal may hinder the principal's ability to perform the remaining work on the existing bonded contracts in a timely manner. Qualified personnel may be taken from the "problem" contracts and put on the new, potentially profitable contracts. Furthermore, the additional bonds may also stretch out the principal's work program beyond a comfortable time frame for the surety; and

3. If, in fact, the principal has severe problems that go beyond the temporary shortage of cash, providing additional bonding for projects that may not be profitable may exacerbate the surety's performance bond claim handling problems in the future, increasing the number of bonded contracts in default and ultimately increasing the surety's loss.

#### **IV THE SURETY'S RIGHT TO FINANCE THE PRINCIPAL**

Before the surety makes the decision to directly finance the principal for the completion of the bonded contracts, the surety must determine whether it has the right in the first instance to finance the principal. The surety's authority to advance or lend money or otherwise provide financial assistance to the principal is normally found in the agreement of indemnity. The surety's right and ability to finance the principal as an option under the performance bond depends on the language of the performance bond itself and any statutes or regulations governing the performance bond.

##### **A. The Agreement of Indemnity**

Most agreements of indemnity taken by sureties contain a provision that allows, but does not require, the surety to guarantee loans or advance or lend money to the principal. For example, a representative agreement of indemnity may state:<sup>15</sup>

The surety, in its sole discretion, is authorized and empowered to guarantee loans or to advance or lend money to the principal. The surety reserves the absolute right to cancel any such guarantee and to cease advancing or lending money to the principal with or without cause and with or without notice to the principal or the indemnitors. All money lent or advanced to the principal by the surety from time to time, or guaranteed for the principal by the surety, and all related costs and expenses incurred by the surety, shall be conclusively deemed to be a loss to the surety for which the principal and the indemnitors shall be liable under the agreement of indemnity. The surety may make such advances or

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<sup>15</sup> This 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.

loans without the necessity of seeing to the application of the proceeds by the principal. The principal and the indemnitors shall be obligated to indemnify and hold harmless the surety in accordance with the terms of the agreement of indemnity for the amount of such advances or loans, notwithstanding that the proceeds or any part thereof have not been utilized by the principal for the purposes for which the money was advanced or loaned by the surety.

If the surety's agreement of indemnity contains a similar provision, the surety may advance or lend money to the principal, with such advances being conclusively deemed to be a loss to the surety for which the principal and the indemnitors are liable to reimburse the surety.

## **B. The Performance Bond**

The fact that the agreement of indemnity may authorize the surety to finance the principal does not necessarily mean that the obligee must accept performance of the bonded contract by the principal being financed by the surety. The surety must review the performance bond and any governing statutes and regulations to determine whether financing the principal is a method for the surety to satisfy its performance bond obligations.

### **1. Miller Act Performance Bond**

Under the Miller Act performance bond, the surety's obligation is void if the principal "performs and fulfills all the undertakings, covenants, terms, conditions, and agreements of the contract." Nothing is said about how the surety is to fulfill its obligations under the Miller Act performance bond if the principal fails to fulfill its obligations under the contract with the federal government.<sup>16</sup>

### **2. AIA Document A311 Performance Bond (February, 1970 Ed.)**

Under the AIA Document A311 Performance Bond, the surety is provided with a number of options:

Whenever Contractor shall be, and declared by Owner to be in default under the Contract, the Owner having performed Owner's obligations thereunder, the Surety may promptly remedy the default, or shall promptly

- 1) Complete the Contract in accordance with its terms and conditions, or
- 2) Obtain a bid or bids for completing the Contract...

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<sup>16</sup> A review of the cases involving the federal government shows that financing the principal has been used by the surety as a means for performing its obligations under the Miller Act Performance Bond. Aetna Cas. and Sur. Co. v. United States, 845 F.2d 971 (Fed. Cir. 1988); Morrison Assurance Co., Inc. v. United States, 3 Cl. Ct. 626 (1983); Great American Ins. Co. v. United States, 841 F.2d 1298, 1300 n.8 (Ct. Cl. 1973).

Certainly, to “obtain a bid” for completing the bonded contract is not surety financing of the principal. However, the surety is authorized to “promptly remedy the default” and to “complete the Contract in accordance with its terms and conditions,” both of which may be performed by surety financing of the principal.

### 3. AIA Document A312 Performance Bond (December, 1984 Ed.)

Under the AIA Document A312 Performance Bond, when the obligee has satisfied its obligations under the performance bond, and the surety’s obligations under the performance bond arise, one of the options of the surety is to promptly, and at the surety’s expense:

- 4.1 Arrange for the Contractor, with consent of the Owner, to perform and complete the Construction Contract;...

One of the ways for the surety to arrange for the principal (the “Contractor”) to perform and complete the bonded contract is by financing the principal.

One issue that is brought into focus by the AIA Document A312 Performance Bond is whether the obligee must consent to or be a party to any financing agreement between the surety and the principal, or even know of the surety financing of the principal. Certainly under the AIA Document A312 Performance Bond, it is a condition of the performance bond that the obligee’s consent be obtained. Where that condition is not required under the particular performance bond, the surety may finance the principal without the knowledge of the obligee. The principal may be on temporary hard times, and believe that if the world at large knows that the surety is financing the principal it will have difficulty staying in business and obtaining new work. The surety may be better off if the world does not know it is financing the principal because knowledge of the financing may generate claims by various persons and entities that are not defined claimants under the payment bond.<sup>17</sup>

As will be described later in this paper, one of the disadvantages of financing the principal without an agreement or understanding with the obligee is that money advanced to the principal under a financing agreement does not decrease the penal sum of the surety’s performance bond.<sup>18</sup> If knowledge of the surety financing of the principal is not a critical factor, the surety may be able to negotiate with the obligee such that the financing of the principal does, in fact, decrease the penal sum of the performance bond by the amount of the surety’s money loaned or advanced to the principal.

## **V. ADVANTAGES AND DISADVANTAGES IN FINANCING THE PRINCIPAL**

There are a number of apparent advantages and disadvantages to surety financing of the principal as a means of discharging the surety’s performance bond obligations. The following is a list of those advantages and disadvantages.

### **A. Advantages in Financing the Principal**

#### 1. Learning Curve

<sup>17</sup> See Section IX.A. of this paper on alter ego claims against the surety.

<sup>18</sup> See Section V.B.1. of this paper.

The principal's management, work forces and subcontractors are familiar with the construction means and methods employed on the project site. A completion contractor requires a certain amount of time to organize and become familiar with the work prior to becoming productive and efficient. This learning curve is expensive, and will be reflected in the completion contractor's bid and in increased liquidated damages. Assuming that the principal is performing the work efficiently and economically, savings can be realized by eliminating the learning curve experienced by a completion contractor.

## 2. Demobilization and Mobilization/Job Momentum and Continuity

If the project is shut down, manpower, equipment and supplies will likely be removed from the project site. The cost of such demobilization by the principal and its subcontractors can be significant and may result in claims against the surety's payment bond. After a relet, the completion contractor will have to mobilize its own forces, subcontractors and suppliers, costing time and money that will be built into the completion contractor's bid.

By providing financing to the principal to enable the principal to continue with the completion of the work on the bonded contract, shutdown of the project is avoided, job disruptions are minimized, subcontractors of the principal remain on the project, and continuity of the work may be maintained. Claims for damages by both the obligee and subcontractors may be minimized. If the bonded contracts are substantially completed, the delays involved in reletting the work, plus liquidated damages and other claims of obligees and subcontractors, may be so substantial that significant cost savings may be achieved by financing the principal.

## 3. Completion Contractor Mark-Up

The completion contractor estimates the cost to complete the work on the bonded contract. The completion contractor has to make allowances in its bid price for obtaining bonds, mobilization, correcting possible defective work and other contingencies that make its price more expensive. The completion contractor must also mark-up the bid price for both profit and overhead. Assuming that the principal is performing the work efficiently and economically, the additional allowances and mark-up, overhead and profit of the completion contractor can be saved by financing the principal.

## 4. Principal's Image and Presence, and Preservation of Claims

By keeping the principal out in front and the surety in the background, many of the problems with obligees and the principal's creditors can be minimized. The appearance of business as usual for the principal, whether or not the presence and assistance of the surety is known, can lessen claims and disputes and improve cash flow from the bonded contracts. By maintaining the presence of the principal, claims for additional compensation against the obligees and backcharges against subcontractors and suppliers are not lost or heavily discounted as occurs when a completion contractor takes over and the surety is forced to litigate claims when the principal is unavailable or uncooperative. The principal's witnesses and documentation necessary to substantiate various claims and backcharges remain available and assessable. Historically, many things that occur on a construction project are "lost" when the principal leaves the project site and is replaced by the completion contractor, thereby increasing the surety's loss.

## 5. Subcontracts

If the surety finances the principal and prevents the termination of the principal's right to proceed, subcontractors and suppliers cannot renegotiate their subcontracts and purchase orders. They are bound to the principal at the prices previously agreed upon. This may represent a substantial advantage on bonded contracts that are heavily subcontracted to others.

## 6 Salvage Considerations

Most sureties require the principal and the indemnitors to provide collateral security to the surety as a condition precedent to the surety rendering financial assistance to the principal. Most principals want to complete their work. At the beginning of the financing arrangement, the principal and the indemnitors are more likely to provide their assets as collateral security to the surety for the financing being advanced. Salvage is made easier because:

(a) The failure to provide collateral security to the surety, if such collateral exists, will in all likelihood influence the surety not to extend financing to the principal;

(b) The principal and the indemnitors feel it is in their best interests to continue working on the bonded contracts to reduce the surety's ultimate loss, and are willing to provide collateral security to the surety to reduce their potential liability; and

(c) By obtaining collateral security at the beginning when financing the principal commences, rather than obtaining collateral security as indemnity and reimbursement once the losses have been incurred, the surety reduces the possibility that its obtaining of collateral security will be deemed to be a preference in the event of a later bankruptcy proceeding filed by the principal and/or the indemnitors.

### **B. Disadvantages in Financing the Principal**

#### 1. No Credit Against the Performance Bond Penalty

Unless agreed to by the obligee, money advanced by the surety to its principal under a financing arrangement does not decrease the penal sum of the surety's performance bond. If the penal sum of the surety's performance bond is in jeopardy because the projected cost to complete the work is close to the penal sum of the performance bond, the surety should refuse to finance the principal. The principal may be reluctant because an agreement with the obligee concerning the surety's advances to the principal and a subsequent credit against the penal sum of the performance bond may defeat the strategy of the surety and the principal to maintain the principal's image and appearance on the project.<sup>19</sup> The obligee may also be reluctant to agree to such a reduction in the penal sum of the performance bond as a result of the surety financing of the principal.

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<sup>19</sup> One commentator has argued that obtaining the obligee's agreement to credit all of the surety's advances and loans to the principal against the penal sum of the performance bond may affect the consideration given by the surety financing the principal. Schroeder No. 2, supra, note 1 at p. 1206. See also Section VII.B., note 29, infra.

## 2. Fixing the Loss

The surety is unable to fix the amount of its loss by financing the principal. The surety will not know the final amount of its loss until the last bonded contract is completed and the financing ends. The surety takes the same risks as any other contractor, including the risks of bad weather, unreliable subcontractors, late deliveries, wrong deliveries, warranty items, lack of bona fide workers, etc. Reletting the work to third parties at a fixed cost (and obtaining performance and payment bonds from the third party completion contractors) establishes the surety's loss.

When the work has barely commenced on one or more bonded contracts, there are many reasons for reletting the work rather than financing the principal, including the following:<sup>20</sup>

(a) The completion contractor does not have to worry about defective work and warranty work, thereby minimizing its price;

(b) The surety may generally obtain an agreement from subcontractors to complete their work for the surety or a completion contractor for the same price as provided to the principal;

(c) Potential completion contractors may generally be found among the original bidders whose existing knowledge of the project requirements based upon their recent bid can save time and money; and

(d) Payment bond obligations are more easily determined because fewer unpaid bills are likely to exist early in the performance of the work.

## 3. Payment of Claims Not Covered by the Performance Bond

The surety financing the principal must frequently satisfy the principal's debts that are not covered by either the performance bond or the payment bond. Specifically, the surety must generally make a substantial contribution to the principal's overhead and general and administrative expenses ("overhead").<sup>21</sup> This contribution may be for overhead incurred in the past, and will certainly include overhead costs going forward. While overhead may be reduced, the reductions in overhead rarely decrease as quickly as the revenues generated from the bonded contracts.

When the principal has extensive unbonded work, the surety faces a dilemma. Unless the surety takes a security agreement and files financing statements to perfect its security interest in unbonded accounts receivable and is perfected ahead of any bank that may have lent money to the principal, the surety should not finance the unbonded work. On the other hand, the surety must ensure that a portion of the overhead is collected from the unbonded contract proceeds.

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<sup>20</sup> Webster, Wayne H., "The Surety's Decision on What to Do." 17 Forum 1168, 1176 (1982) (hereinafter referred to as Webster).

<sup>21</sup> In reality, the surety will make a contribution to someone's overhead and general and administrative expenses. If the bonded contract is completed by a completion contractor, the completion contractor will include overhead in its bid price. If the obligee completes the work, it will make a claim for its overhead and general and administrative expenses against the surety's performance bond.

Under any scenario, financing the principal will increase the surety's loss because of necessary expenditures on unbonded obligations. The surety must be certain that financing will decrease its eventual total loss notwithstanding the payment of obligations that would not otherwise be due under the performance or payment bonds.

#### 4. Costs of Monitoring the Work

The costs of monitoring the work of a financed principal can be large depending on the individual situation. Frequently, the surety's representative must spend substantial time in the principal's office and with the principal's project managers to ensure that the work is being performed, requisitions on the bonded contracts are being submitted and paid timely, and that the correct bills are being paid. The surety's representative must also deal on a continuous basis with the representatives of the obligees. Frequently, consultants are required to assist the surety's representative in monitoring the work. To the extent that any legal issues arise, the surety will incur additional attorneys' fees. Finally, when there are multiple bonded contracts and hundreds of checks involved, an outside accounting firm may be required in order to keep track of the surety's payments and losses and the receipt of bonded contract funds for purposes of reinsurance and indemnity claims against indemnitors.

#### 5. Completing the Work - The 10% Problem<sup>22</sup> and Tail-End Let-Downs<sup>23</sup>

The achievement of substantial completion by the financed principal can be difficult. Many principals have a problem in completing the last 10% of the work under any circumstances. When the principal is going out of business, the principal and its employees may have less interest in completing the projects. At the same time, there may be more incentive to prolong the work in order to obtain a paycheck as opposed to completing the work and ending the financing by the surety. Many problems arise when the work towards substantial completion is reached, and all can cause serious time problems that increase the surety's loss.

#### 6. Problems of Reinsurance

Many of the reinsurance treaties require extensive reporting by the surety to the reinsurers, and most require prior approval by the reinsurers before the surety commits to financing the principal.<sup>24</sup> While the existence of reinsurance is not, in and of itself, a disadvantage, the time and requirements in dealing with the reinsurers must be calculated in any financing arrangements with the principal.

#### 7. Risks to the Surety Beyond the Penal Sum of the Performance Bond

There are certain risks to the surety in financing the principal that may extend the surety's loss beyond the terms and penal sum of its performance bond. Those risks are more fully discussed below in Section IX.

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<sup>22</sup> Joyce and Haug, supra. note 1 at p. 26.

<sup>23</sup> Webster, supra. note 20 at p. 1176.

<sup>24</sup> Schroeder No. 1, supra. note 1 at p. 832, n. 5.

## **VI. FINANCING THE SUBCONTRACTOR PRINCIPAL**

Many of the issues in determining whether the surety should finance the principal when the principal is a general contractor are similar when the principal is a subcontractor. The same kind of information and analysis is necessary, the surety must determine if it has a right to finance the subcontractor principal, etc. Assuming that the surety has knowledge that the subcontractor principal is in financial difficulty and has the opportunity make its analysis prior to the subcontractor principal's termination for default, there may be a reduction in the amount of the financing surety's loss when the subcontractor principal faces termination on an ongoing bonded contract.

For example, when the principal operating as a general contractor is terminated for default, whether or not the surety has the opportunity or the desire to consider financing, work on the bonded contract stops. When a subcontractor principal gets into financial difficulties, and there is a prospect of a termination for default, the overall project keeps going. Depending upon the construction contract involved, and the status of the work of the subcontractor principal, it may be more beneficial to allow the subcontractor principal to continue to perform the work (electrical, mechanical, etc.) rather than face the claims of the obligee (general contractor) based upon delays and disturbances to the general contractor's work and to the work of other subcontractors.

## **VII. PROCEDURES AND MECHANICS FOR FINANCING THE PRINCIPAL**

When the surety's decision is made to finance the principal, whether for one bonded contract or for many bonded contracts, the surety should require a separate agreement with the principal and the indemnitors.<sup>25</sup> Whether the agreement is referred to as a "Joint Control Trust Account Agreement," a "Financing and Collateral Agreement," or some other name (hereinafter referred to as the "Agreement"), certain provisions concerning the procedures and mechanics governing the financial arrangement between the surety and the principal (and the indemnitors) are necessary. The Agreement should set forth certain recitals; reaffirm the indemnity obligations of the principal and the indemnitors to the surety; provide collateral security to the surety for its agreement to finance the principal; provide for the establishment of a joint control trust checking account or some other bank trust account arrangement for the receipt and collection of bonded contract funds and monies advanced or loaned by the surety to the principal, and for the payment of the bills incurred by the principal on the bonded contracts; provide a description of the bills to be paid and the procedures for paying the bills from the trust account; set forth the provisions for terminating the Agreement; provide, where appropriate, for the sale of the collateral security given by the principal and the indemnitors to the surety and for the reimbursement and repayment of the surety for its financing of the principal;<sup>26</sup> and set forth certain miscellaneous provisions that govern the understandings,

<sup>25</sup> Several commentators have addressed the issue of the extent of the surety financing of the principal and whether it should extend to unbonded work of the principal. See *Joyce and Haug, supra*, note 1 at p. 28 ("Financing the completion of work that you are contractually obligated to complete is risky enough without taking on additional risks. This can be short-sighted, however. If the unbonded work appears to be profitable, financing it can help to pay for the completion of the bonded work.") *Joyce and Haug* list a number of factors to maximize the surety's chances for successfully financing unbonded work. *Id.* See also *Schroeder No. 2, supra*, note 1 at p. 1203-05.

<sup>26</sup> A discussion of all of the types of any provisions that may be in an agreement for the reimbursement and repayment of the surety for its financing of the principal is beyond the scope of this paper. Frequent provisions found in a repayment agreement include: periodic payments over time, including balloon payments; agreements concerning the sale and liquidation of certain collateral security, and the use of the net proceeds of sale; a description of the surety's rights and remedies in the event that the

relationships and construction of the Agreement between and among the surety, the principal and the indemnitors.

Attached as Appendix A to this paper is a draft Financing and Collateral Agreement between and among the principal, the indemnitors and the surety. While no one Agreement can necessarily set forth all of the understandings among the principal, the indemnitors and the surety for every case, the attached Agreement provides the framework for any such understandings.

## **A. Recitals**

The recitals are important in any Agreement because they set forth the basic factual understandings among the principal, the indemnitors and the surety at the beginning of the financing arrangement. The recitals should contain and/or refer to the following:

1. A description of the existing agreement(s) of indemnity, with copies attached;
2. An attached list of the relevant contracts and the bonds executed by the surety on behalf of the principal for those contracts;<sup>27</sup>
3. An acknowledgment that the bonds executed by the surety were induced by and provided in reliance upon the execution of the agreement of indemnity by the principal and the indemnitors, who should acknowledge and reaffirm their joint and several obligations and liabilities to the surety under the agreement of indemnity;
4. A statement as follows:

WHEREAS, the contracts are in various stages of completion, and the principal and the indemnitors hereby acknowledge and admit that: (a) the principal is financially unable to perform or complete the performance of the contracts; (b) certain subcontractors and suppliers of labor and/or materials with respect to the contracts and projects have not been paid; (c) the principal has requested the financial assistance of the surety as a result of (a) and (b) above; and (d) but for the willingness of the surety to enter into the Agreement, the principal is unable to complete the performance of the contracts and pay its subcontractors and suppliers of labor and/or materials with respect to the contracts and projects; and

5. An acknowledgement that the Agreement is a financial accommodation extended by the surety to the principal and the indemnitors.

The recitals should also state any specific facts that exist that have induced the surety to enter into the Agreement to finance the principal.

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principal and the indemnitors default under the terms of the repayment agreement; and the return of any collateral not necessary for the full reimbursement of the surety. Each case will have its own facts and require the drafting of specific repayment provisions to comply with the particular circumstances of the case. See also Section VII.E. of this paper.

<sup>27</sup> See Exhibit 2 to the Financing and Collateral Agreement attached as Appendix A to this paper at p. A-26.

## **B. Indemnification**

The principal and the indemnitors should, within the body of the Agreement, acknowledge and reaffirm their joint and several obligations and liabilities to the surety under the agreement of indemnity. The indemnification section of the Agreement should also contain the following:

1. The granting of a lien and/or security interest in all of the real and personal property (including the bonded contract funds) of the principal and the indemnitors as described in an exhibit to the Agreement.<sup>28</sup> The surety should take all steps necessary to record its liens on real property and perfect its security interest in the personal property by filing the appropriate financing statements. Not only does the agreement of indemnity provide the basis for a demand for collateral security, but the principal and the indemnitors are usually willing to provide to the surety what collateral security they can in order to obtain surety financing in accordance with the terms of the Agreement.<sup>29</sup>

2. The principal should provide Voluntary Letters of Default and Termination for each of the contracts bonded by the surety.<sup>30</sup> The surety should be given the right to use the Letters of Default, individually as to each of the bonded contracts or as to all of the bonded contracts, at the surety's sole option and discretion.

## **C. Establishment of the Joint Control Trust Checking Account**

The Agreement should provide for the opening of a joint control trust checking account (the "Trust Account"). The Trust Account should be established with a bank in accordance with a separate Trust Account Agreement setting forth those substantive portions of the Agreement relating solely to the Trust Account.<sup>31</sup>

Initially, the surety and the principal must decide on the bank to be used for the establishment of the Trust Account. There are three issues that arise in choosing the appropriate bank.

The first issue is whether the bank has the willingness, ability and capability to establish and maintain the Trust Account. Many banks are unwilling or unable to provide the necessary services in creating and maintaining the Trust Account that provides the surety with the necessary protection. Furthermore, attempting to establish such a Trust Account at a bank

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<sup>28</sup> See Exhibit 3 to the Financing and Collateral Agreement attached as Appendix A to this paper at p. A-27. See Section IX.D. of this paper concerning the potential liabilities of the surety for hazardous wastes located on real estate which may be subject to the surety's liens.

<sup>29</sup> Commentators have raised the issue of whether surety financing of the principal is sufficient consideration for obtaining collateral security. There are really two issues. First, is surety financing of the principal anything more than the surety performing its obligations under the performance bond? Second, if the surety does not commit itself to financing the principal, or perhaps providing new bonds in the future for the principal, is there sufficient consideration? These issues have been raised, and the answers are probably that surety financing is sufficient consideration in order to obtain collateral security. See Schroeder No. 1, supra, note 1 at p. 841 and p. 863; Schroeder No. 2, supra, note 1 at p. 1205-07.

<sup>30</sup> See Exhibit 4 to the Financing and Collateral Agreement attached as Appendix A to this paper at p. A-31.

<sup>31</sup> See Exhibit 5 to the Financing and Collateral Agreement attached as Appendix A to this paper at p. A-32.

unwilling or unable to accept the surety's terms and conditions may cause a delay in the establishment of the Trust Account and the payment of subcontractors and suppliers through the Trust Account, thereby requiring those necessary payments to be made with surety claim drafts. One should not assume that opening a Trust Account will be quick or easy.

Second, notwithstanding the trust nature of the Trust Account,<sup>32</sup> certain creditors of the principal may attempt to attach or garnish the funds in the Trust Account. There are few banks that are willing to ignore such an attachment or garnishment at the surety's request, with or without the surety's indemnity. The best the surety can ask for is to receive notice of any such attachment or garnishment in time to go to court to try to have the attachment or garnishment released.

Third, the principal may be a customer of the bank chosen to establish the Trust Account. The Trust Account Agreement provides that none of the contract funds or any monies advanced or loaned by the surety to the principal and deposited in the Trust Account "shall be subject to any right of set-off by the [b]ank as a result of any transactions involving the [b]ank and the [p]rincipal."<sup>33</sup>

When the Trust Account is established, all contract funds from the bonded contracts and all monies loaned or advanced by the surety to the principal should be deposited into the Trust Account. The Agreement provides that letters of direction will be sent by the principal to the obligees of the bonds requesting that the bonded contract funds be made payable jointly to the principal and the surety and sent to the surety for deposit into the Trust Account.<sup>34</sup> The principal should execute an Assignment and Power of Attorney authorizing the surety to endorse the checks received from the obligees and to deposit the checks into the Trust Account.<sup>35</sup>

The Agreement should provide that all of the funds in the Trust Account, whether contract funds received from the bonded contracts or monies loaned or advanced by the surety to the principal, are held in the Trust Account as trust funds for the uses and purposes set forth in the Agreement.<sup>36</sup> There are a number of ways to establish the Trust Account with the bank, depending upon the complexity of the case, the proximity of the surety's representative to the principal's office and records, and the number of checks involved on a weekly or monthly basis. Two of these methods include the following:

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<sup>32</sup> For a detailed discussion of the trust fund nature and characteristics of a trust account, see Schroeder No. 1, supra, note 1 at p. 851-54; Schroeder No. 2, supra, note 1 at p. 1209-10; Joyce and Haug, supra, note 1 at p. 35.

<sup>33</sup> See Exhibit 5 to the Financing and Collateral Agreement attached as Appendix A to this paper, paragraph 11, page A-36. For a discussion concerning the issue of dealing with the principal's assignee bank, see Schroeder No. 1, supra, note 1 at p. 854-57.

<sup>34</sup> See Exhibit 6 to the Financing and Collateral Agreement attached as Appendix A to this paper at p. A-39. While a Letter of Direction from the principal to the obligee will assist the surety in collecting the bonded contract funds, it is not enough for a surety to protect its rights in the bonded contract funds from other third-parties. The surety may assert its rights of subrogation, or its secured rights under the UCC if it has either recorded its agreement of indemnity or obtained a security interest under the Agreement and filed financing statements to perfect that security interest. See Schroeder No. 2, supra, note 1 at p. 1200-01.

<sup>35</sup> See Exhibit 7 to the Financing and Collateral Agreement attached as Appendix A to this paper at p. A-40. For a discussion of powers of attorney taken by a surety financing the principal, see Schroeder No. 2, supra, note 1 at p.1208-09.

<sup>36</sup> See note 32, supra, for commentaries on the trust fund nature of the Trust Account. The drafter of the Agreement must make sure that the language in the Agreement complies with state law requirements to establish a bona fide express trust.

1. Joint Control Trust Checking Account

The most common method, and the method described in the Agreement attached as an Appendix (and in Exhibit 5, the Trust Account Agreement), is to use one Trust Account. Each check from the Trust Account requires the signature of two people: (a) the surety's representative; and (b) the principal's representative. All bonded contract funds collected and any monies loaned or advanced by the surety are deposited directly to the Trust Account. All withdrawals from the Trust Account for the purposes described in the Agreement (see below) are made by a check signed jointly by the surety and the principal. While this method gives the surety control over the trust funds in the Trust Account and is a fairly simple method of paying bills, it can be time consuming and create logistical problems. The surety's representative may be located far away from the principal's office, checks and backup documentation must be sent by overnight mail, and, at times, tens and hundreds of checks requiring the signature of the surety's representative may be necessary on a monthly basis. However, signing checks may provide the surety's representative with a good opportunity to visit the principal to see how the bonded contracts are progressing and to discuss any other relevant issues.

2. Two Trust Accounts and an Operating Account

A second method is to use two Trust Accounts (Trust Account No. 1 and Trust Account No. 2) and an Operating Account. The Operating Account requires the sole signature of the principal. It is a zero-balance account that draws its funding from Trust Account No. 2. There is never any money in the Operating Account. All bonded contract funds and any monies loaned or advanced by the surety to the principal are deposited into Trust Account No. 1. The principal presents the surety with a request for the payment of numerous bills along with checks drawn on the Operating Account that require only the principal's signature. The surety and the principal then agree to the bills to be paid and to the amount of funding from Trust Account No. 1 to Trust Account No. 2 to cover the checks drawn on the Operating Account. Through the use of passwords and facsimile machines, the surety and the principal give approval to the bank to transfer the agreed upon amount of funds from Trust Account No. 1 to Trust Account No. 2. The surety or the principal will then transmit the checks from the Operating Account to the payees. When the checks are returned to the bank on the zero-balance Operating Account, funds are immediately drawn by the bank from Trust Account No. 2 to cover the checks presented on the Operating Account. The surety will know that there is a problem in the arrangement when the bank notifies the surety that Trust Account No. 2 is overdrawn. This can only occur when checks for amounts or in numbers in excess of those approved by the surety to be sent from the Operating Account are presented on the Operating Account, and there are insufficient funds in Trust Account No. 2 to cover those checks.

**D. Use of the Contract Funds From the Trust Account**

The Agreement should set forth specifically how the trust funds contained in the Trust Account, whether bonded contract funds or monies loaned or advanced by the surety to the principal, must be used. The Agreement provides for the following:

## 1. Use of Trust Funds

The trust funds in the Trust Account should be used solely for the payment of all labor and material costs, including amounts due to subcontractors and suppliers and for rental of equipment incurred by the principal and the principal's subcontractors and suppliers, which are necessary to complete the work under the bonded contracts and for which the surety may become liable under its bonds. The trust funds in the Trust Account should also be used to repay and reimburse the surety in accordance with the terms of the Agreement. The Agreement should specifically state that the trust funds in the Trust Account should not be used to pay obligations of the principal on contracts not bonded by the surety.

## 2. Overhead and General and Administrative Expenses of the Principal

The provision for the payment of the overhead and general and administrative expenses of the principal is one of the most difficult to negotiate. In any financing arrangement, certain expenses of the principal must be paid that are not attributable to direct bonded contract costs for which the surety would be liable under its bonds. These include home office salaries and expenses, insurance of all types (general liability, automobile, health, life, etc.), rent, telephone, photocopying, postage, legal and accounting services, etc. The principal that wants to stay in business is always concerned about the funding of its overhead to maintain continuity and cohesion. The surety wants to reduce its exposure for the payment of unbonded obligations.

There are a number of ways to approach the payment of the principal's overhead and general and administrative expenses in the Agreement,<sup>37</sup> including the following:

(a) The surety may require its review and approval of all payment of overhead expenses. The Agreement attached as an Appendix does not obligate the surety to pay the principal's overhead. To the extent that the surety consents to the payment of overhead from the Trust Account, such consent is at the surety's sole option and discretion; or

(b) The surety may provide a set percentage of the monthly contract funds collected from the bonded contracts to be used to pay for the principal's overhead and general and administrative expenses. This percentage payment from the Trust Account would be the surety's sole contribution to the principal's overhead unless the surety, in its sole discretion, authorized additional specific payments requested by the principal. The surety would have no other obligation to fund the overhead expenses beyond the agreed percentage.

No matter what "agreements" are reached or what method is chosen by the surety and the principal to fund the principal's overhead, there will be disagreements and disputes between the surety and the principal because of a basic underlying conflict - the principal wants everything paid while the surety wants to control the payment of expenses and reduce its losses.

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<sup>37</sup> For a discussion concerning the payments to be made from the Trust Account, including overhead, see Schroeder No. 1, supra, note 1 at p. 845-48.

### 3. Payment of the Principal's Bills

The Agreement should set forth with specificity the arrangements between the principal and the surety for the payment of the principal's bills.<sup>38</sup> The Agreement attached as an Appendix sets forth these procedures in Section III, Paragraphs 4(a) through 4(h). Generally, the procedures should be as follows:

(a) The principal should provide a written request and sufficient backup documentation for each payee for each check drawn on the Trust Account and signed by the principal. There should never be any question that the principal has requested that a particular payment be made (i.e., by the principal's signature on the check) and has acknowledged that the amount of the check is currently due and owing to the payee named on the check. The surety must collect and review all of the backup documentation in order to assure itself that the payments are due on the bonded contracts and are in the correct amounts.

(b) To the extent that the contract funds in the Trust Account are sufficient to make the payments requested by the principal and approved by the surety, the checks should be signed by the surety and sent by the surety, along with any releases, to the payees. It is important that the surety retain the ability to disapprove any payments requested by the principal. The Agreement attached as an Appendix provides as follows:

It is expressly understood by the Principal and the Indemnitors that should the Surety or its representative disapprove any payments requested by the Principal or refuse to countersign any check drawn on the Trust Account, such decision is final as to the Principal and the Indemnitors, and the Principal and the Indemnitors shall have no right or cause of action of any kind or nature against the Surety, its agents, employees, attorneys or representatives as a result of such disapproval.

(c) To the extent that the contract funds in the Trust Account are insufficient to make the payments requested by the principal and approved by the surety, the surety may loan or advance monies to the principal or the Trust Account for the payment of those bills. The Agreement provides that any such advances to, loans to or funding of the principal or the Trust Account:

(1) Shall be conclusively presumed to be a loss to the surety; and

(2) Shall constitute and be deemed to be trust funds in the Trust Account.

(d) The treatment of the principal's payroll (as opposed to the payment of the principal's subcontractors and suppliers) is handled differently in the Agreement. Frequently, the principal has an automated system for the payment of its payroll, including the net pay for each employee, taxes to be withheld, and all other deductions. Many times it is easier for the surety to fund the principal's existing payroll account directly from the Trust Account rather than prepare checks for each employee on a weekly or bi-weekly basis from the Trust

<sup>38</sup> See Schroeder No. 1, supra, note 1 at p. 847-48 for the types of bills that might be identified and paid.

Account. There are three risks in funding the principal's existing payroll account directly from the Trust Account:

(1) The funds transferred to the principal's existing payroll account from the Trust Account are no longer subject to the joint control rights of the surety. While it is unlikely that the principal will divert these funds from its payroll account and use them for other purposes, thereby leaving its employees unpaid (or with checks that bounce), the possibility exists;

(2) The funds transferred from the Trust Account to the principal's existing payroll account at the bank are no longer "trust funds." If the principal is indebted to the bank, the bank may have a right of setoff against the principal's payroll account. If this occurs, the funds will be gone, the employees will be unpaid, and the surety may have to pay a second time. This "occurrence" can be avoided if the principal does not have any debt obligations to the bank that handles the principal's payroll account, or a separate agreement is reached among the principal, the surety and the bank that the bank will not exercise any setoff rights it may have against the principal's payroll account; and

(3) The funds transferred to the principal's existing payroll account are at risk to the attachments or garnishments of judgment creditors of the principal, and no longer have any trust fund characteristics.

(e) Of critical importance to the surety is the payment of all withholding and payroll taxes and other amounts deducted from employee wages. Under the Miller Act performance bond, the surety is liable for certain payroll taxes regardless of whether the surety finances the principal or not. Under the Internal Revenue Service statutes and regulations, the surety may be deemed to be in control of the principal to such extent that the surety may be responsible for the payment of withholding and payroll taxes if the principal fails to make those payments.<sup>39</sup> The Agreement attached as an Appendix provides for the direct funding from the Trust Account of all taxes and other deductions from the principal's payroll.

#### **E. Sale of the Principal's and/or the Indemnitors' Collateral Security**

In the event that the principal and/or the indemnitors provide collateral security to the surety, it is helpful to provide in the Agreement for the sale of the collateral, whether it is real property or personal property. While the negotiations for the sale of the collateral will be very case specific, and may require too much time initially to work out a resolution if financing is needed quickly, the Agreement provides certain general guidelines for the sale of the collateral, the representations by the principal and the indemnitors, the documentation concerning the sale of collateral, and the use of the net proceeds of any sale of collateral.

#### **F. The Surety's Right to Repayment and Reimbursement**

Whenever a surety incurs a loss, it wants to be repaid and reimbursed as soon as possible. The Agreement should provide a prompt repayment and reimbursement of the surety from either excess contract funds or the proceeds of any sale of collateral.

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<sup>39</sup> See Section IX.C. of this paper concerning tax liabilities.

## **G. Takeover Rights of the Surety**

Pursuant to the terms of the Agreement, the surety should receive Letters of Default from the principal with the right to use them at the surety's sole option and discretion. The Agreement should provide certain rights to the surety in the event that the surety sends the Letters of Default to one or more obligees and takes over the completion of the work under the bonded contracts. The Agreement provides for various takeover rights of the surety. Many agreements of indemnity also provide similar takeover rights. A surety's takeover rights under the Agreement should be broader and stronger than the surety's takeover rights under the agreement of indemnity.

## **H. Termination**

Terminating the Agreement is another difficult drafting area when negotiating a financing arrangement with the principal.<sup>40</sup> The surety wants to retain the ability to terminate the Agreement at its sole option and discretion. The principal and the indemnitors want to terminate the Agreement as soon as possible. Since the surety is looking to the joint control of the contract funds as a means to ensure that they are used to pay bills on the bonded contracts, and also wants to be repaid for its losses and advances to the principal, including interest, the Agreement may last for a long time, including through the liquidation of the collateral security of the principal and the indemnitors.

The Agreement attached as an Appendix has a simple repayment agreement between the principal and the indemnitors and the surety. Frequently, a repayment plan, with or without the sale of collateral, is difficult to negotiate at the beginning of the financing arrangement because the surety's ultimate loss is unknown and the urgency is for the surety to obtain control of the bonded contract funds and to pay the bills of subcontractors and suppliers to keep the principal's momentum going on the bonded contracts. If a repayment agreement exists in the financing arrangement, the termination provision of the Agreement will normally tie in with the repayment agreement.

One right the surety must have at all times is the ability to draw down on the Trust Account to reimburse itself for its loans, advances, losses and expenses as contract funds build up in the Trust Account. The Agreement attached as an Appendix has a provision whereby the surety is permitted to reimburse itself on an ongoing basis from the trust funds in the Trust Account.

## **I. Miscellaneous Provisions**

There are a number of miscellaneous provisions that are recommended:

### **1. Agreement that the Surety has no Obligation to Provide Financing**

It is critical that the principal and the indemnitors acknowledge and agree that the surety has no obligation to fund the Trust Account, provide financial assistance to the principal in any manner or method, or make any payments other than those payments for which the surety has specifically agreed to make pursuant to the terms of the Agreement. Furthermore,

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<sup>40</sup> See Schroeder No. 2, supra, note 1 at p. 1211-13 for certain concerns on termination of the surety financing of the principal.

the funding of the Trust Account by the surety is in the surety's sole option and discretion and does not bind or commit the surety to any further funding of the Trust Account.<sup>41</sup>

2. Agreement on the Execution of Future Bonds for the Principal

Unless otherwise agreed, the surety should require the principal and the indemnitors to acknowledge and agree that their execution of the Agreement has not been induced by or made in reliance upon any oral or written representations by the surety or any of its agents, including a representation that the surety will execute any future bonds on behalf of the principal.

3. Books and Records and Access to the Bonded Contract Job Sites

The principal should be required to maintain accurate books, records and accounts, and make them available for the surety's examination. Furthermore, the principal should specifically authorize the surety and its representatives to visit at any time the bonded contract job sites, and to obtain whatever project records and information deemed necessary by the surety from any source, including the obligees, subcontractors, suppliers, etc.

4. Other General Provisions

The Agreement attached as an Appendix contains other general provisions that should be reviewed and considered for any financing Agreement among the principal, the indemnitors and the surety.

**J. Summary**

There is no one set of procedures and mechanics for the surety financing the principal. The Agreement attached as an Appendix and the above discussion deal with the most prevalent issues that arise when the surety finances the principal. Each case requires something different based upon the circumstances involved. The above discussion and the Agreement attached as an Appendix serve as a checklist for the kinds of provisions in such an Agreement that the surety should consider.

**VIII. FINANCING THE PRINCIPAL IN BANKRUPTCY**

Space limitations allow only a brief discussion of surety financing of a principal that has filed a chapter 11 bankruptcy proceeding. Other commentators have written more extensively on the subject.<sup>42</sup>

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<sup>41</sup> While there may be an issue of consideration (see note 29, *supra*), the author and other commentators would not recommend that a surety commit itself to pay the overhead and general and administrative expenses of the principal or to complete each of the bonded contracts. See Schroeder No. 2, *supra*, note 1 at p. 1195.

<sup>42</sup> See Leo, *supra*, note 5. Mr. Leo's paper was originally presented at the ABA Forum Committee on the Construction Industry and the Fidelity and Surety Law Committee Joint Program on January 26, 1989. Missing from the published article in the Tort and Insurance Law Journal are extensive exhibits and forms which may be found with the unpublished article presented at the Forum Committee/FSLC Joint Program on January 26, 1989. The exhibits and the forms are valuable, substantive materials to review. See also Bachrach, George J. and Rodgers-Waire, Cynthia E., "The Surety's Rights to the Contract Funds in the Principal's Chapter 11 Bankruptcy Case," 35 Tort and Insurance Law Journal 1 (1999); The Law of Suretyship, 2nd Ed., Chapter 20 (Edward G. Gallagher ed., 2000) entitled "Bankruptcy and the Surety" by Chad L. Schexnayder; The Law of Performance Bonds, Chapter 12 (Lawrence R. Moelmann and John T. Harris eds., 2000) entitled "Bankruptcy" by Chad L. Schexnayder; Shahinian and Clarke,

The surety faces two financing possibilities when the principal files its chapter 11 bankruptcy proceeding. First, the surety may already be financing the principal pursuant to an Agreement, receiving the bonded contract funds, depositing them into the Trust Account, and jointly controlling their use. Second, the principal, with or without prior notice to the surety, after filing its chapter 11 bankruptcy proceeding may request financing from the surety. Substantively and strategically, it may be easier for the surety to approach the Bankruptcy Court requesting the reinstatement of the Agreement and all of its protections in return for surety financing of the principal/debtor during the chapter 11 bankruptcy proceeding. The surety's argument is that the rights, remedies, mechanics and procedures have already been established and constitute adequate protection for the surety. However, regardless of whether the Bankruptcy Court adopts the prior Agreement, or whether some other financing arrangement must be negotiated with the now principal/debtor, the following issues and rights should be encompassed in any financing arrangement between the surety and the principal/debtor, and approved by an appropriate Bankruptcy Court order after notice and a hearing.

#### **A. Advancing or Lending Money to the Principal/Debtor**

Section 364 of the Bankruptcy Code<sup>43</sup> provides that a debtor authorized to operate its business may “obtain unsecured credit and incur unsecured debt in the ordinary course of business...as an administrative expense.”<sup>44</sup> Therefore, the principal/debtor may purchase inventory and materials on an unsecured basis and incur other unsecured debt in the ordinary course of business, and those debts will be paid as administrative expenses on an ongoing current basis ahead of the claims of pre-petition unsecured creditors. However, if the principal/debtor requires the surety's financial assistance, Bankruptcy Court approval, after notice to all creditors, is required.<sup>45</sup> The surety should not agree to provide financing to the principal/debtor with such advances treated merely as an administrative expense. The Bankruptcy Code provides a number of alternatives for the Bankruptcy Court to provide protection to the surety beyond an administrative expense, including a super-priority administrative expense, liens on property of the principal/debtor's estate not subject to lien rights, rights secured by a junior lien on property of the estate that is subject to lien, or by priming a prior lien.<sup>46</sup>

The provisions and remedies for the protection of one providing credit or advancing or loaning funds to the principal/debtor are geared toward secured lenders and not the needs of the surety. While the surety would like additional financial protection for the advances and loans made to the principal, the surety has other issues that should be addressed that are not found in the typical lending situation. Therefore, if the surety agrees to finance the

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supra, note 5; The Law of Suretyship, Chapter 9 (Edward G. Gallagher ed., 1993) entitled “Suretyship and the Bankruptcy Code,” by T. Scott Leo and Gary A. Wilson.

<sup>43</sup> 11 U.S.C. § 364.

<sup>44</sup> 11 U.S.C. § 364(a).

<sup>45</sup> 11 U.S.C. § 364(b).

<sup>46</sup> 11 U.S.C. §§ 364(c) and (d).

principal/debtor during its chapter 11 bankruptcy proceedings, the surety should also obtain the rights described below in a Bankruptcy Court order.

## **B. Additional Rights for the Protection of the Surety**

In addition to section 364, other sections of the Bankruptcy Code concern issues that are of significant importance to the surety.

### **1. Section 363 of the Bankruptcy Code [11 U.S.C. § 363]**

Section 363 provides that the principal/debtor may not use “cash collateral” as defined in section 363 unless

- (A) each entity that has an interest in such cash collateral consents; or
- (B) the court, after notice and a hearing, authorizes such use,...in accordance with the provisions of this section.<sup>47</sup>

Furthermore, an entity that has an interest in the cash collateral may request the court to prohibit the use of such cash collateral unless the debtor provides adequate protection for the interest of that entity.<sup>48</sup>

A number of commentators have discussed the rights of the surety to the bonded contract funds as cash collateral.<sup>49</sup> Section 363 of the Bankruptcy Code does not require that the interest in “cash collateral” be a UCC security interest.<sup>50</sup> The surety has several possible types of interests in the bonded contract funds:<sup>51</sup>

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<sup>47</sup> 11 U.S.C. § 363(c)(2).

<sup>48</sup> 11 U.S.C. § 363(e).

<sup>49</sup> See Bachrach, George J. and Rodgers-Waire, Cynthia E., “The Surety’s Rights to the Contract Funds in the Principal’s Chapter 11 Bankruptcy Case,” 35 Tort and Insurance Law Journal 1 (1999); Burch, John V. and Purcell, Wade H., “Cash Collateral Litigation and the Surety,” an unpublished article presented to the Fidelity and Surety Law Committee of the Tort and Insurance Practice Section of the American Bar Association on August 10, 1993; The Agreement of Indemnity: Practical Applications by the Surety (American Bar Association, 1989), Chapter 2 entitled “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” by Robert L. Lawrence, Robert M. Wright, George J. Bachrach and William M. Dolan, III (hereinafter referred to as Lawrence).

<sup>50</sup> 11 U.S.C. § 363(e). The Bankruptcy Code defines “cash collateral” as meaning “cash,...in which the estate and an entity other than the estate have an interest...” 11 U.S.C. § 363(a). The word “interest” is not defined under the Bankruptcy Code. 11 U.S.C. § 101. However, the term “security interest” is defined under the Bankruptcy Code and means a “lien created by an agreement.” 11 U.S.C. § 101(51). It is clear that the word “interest” is more inclusive than a mere “security interest,” that the definition of “cash collateral” in the Bankruptcy Code does not limit the surety’s “interest” to a “security interest,” and that the “interest” may include rights other than 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, at 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 contractual rights and its subrogation rights. See also National Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843 (1st Cir. 1969).

<sup>51</sup> Bachrach, George J. and Rodgers-Waire, Cynthia E., “The Surety’s Rights to the Contract Funds in the Principal’s Chapter 11 Bankruptcy Case,” 35 Tort and Insurance Law Journal 1 (1999) (hereinafter referred to as Bachrach).

(a) As a UCC secured party if the surety has previously filed its agreement of indemnity as a financing statement<sup>52</sup> or if the surety has filed financing statements against the bonded contract funds pursuant to an Agreement executed by the principal/debtor prior to the filing of its chapter 11 bankruptcy proceeding;<sup>53</sup>

(b) Pursuant to the trust fund provision of the agreement of indemnity;<sup>54</sup>  
and/or

(c) Pursuant to the surety's subrogation rights to the rights of others.<sup>55</sup>

The surety must take all steps necessary to protect its rights to the bonded contract funds regardless of whether there is a prior existing agreement to finance the principal/debtor. If the surety agrees to finance the principal/debtor during the chapter 11 bankruptcy proceedings, it must obtain all rights to the bonded contract funds under section 363 of the Bankruptcy Code and control over the use of the bonded contract funds pursuant to a financial arrangement with the principal/debtor along the lines of the Agreement,<sup>56</sup> and a Bankruptcy Court order.

## 2. Section 365 of the Bankruptcy Code [11 U.S.C. § 365]

Section 365 of the Bankruptcy Code authorizes the debtor to assume, assume and assign, or reject any executory contract.<sup>57</sup> A pre-existing financing Agreement between the surety and a principal/debtor may or may not be an executory contract that must be assumed or rejected by the principal/debtor. However, unless substantially completed, the underlying construction contracts for which the surety executed its bonds are most certainly executory contracts subject to assumption or rejection.

Under the Agreement, the surety receives Voluntary Letters of Default and Termination and the right to use those Letters of Default for specific construction contracts or all of the

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<sup>52</sup> Bachrach, supra, note 51 at p. 12; Leo, supra, note 5 at p. 51; Shahinian and Clarke, supra, note 5 at p. 15.

<sup>53</sup> Leo, supra, note 5 at p. 47; Franks, J. Michael and Rowland, John H., "Surety Strategy in the Chapter 11 Proceeding: Case Study of a Broke Contractor" at p. 6, an unpublished article presented to the Fidelity and Surety Law Committee of the Tort and Insurance Practice Section of the American Bar Association on August 10, 1993.

<sup>54</sup> Bachrach, supra, note 51 at pp. 13-20; In re Alcon Demolition, Inc., 204 B.R. 440 (Bankr. D.N.J. 1997); In re Jenkins, 110 B.R. 74 (Bankr. M.D. Fla. 1990); cf., In re Construction Alternatives, Inc., 2 F.3d 670 (6th Cir. 1993). See also Lawrence, supra, note 49 at p. 133-54.

<sup>55</sup> The Law of Suretyship, 2nd Ed., Chapter 23 (Edward G. Gallagher ed., 2000) entitled "The Surety's Subrogation Rights," by George J. Bachrach and John V. Burch, Section V.B.5; Bachrach, supra, note 51 at pp. 20-34; The Law of Suretyship, Chapter 26 (Edward G. Gallagher ed., 1993) entitled "The Surety's Subrogation Rights" by George J. Bachrach and John V. Burch, Section V.B.5; Leo, supra, note 5 at p. 59; Universal Bonding Ins. Co. v. Gittens & Sprinkle Enterprises, Inc., 960 F.2d 366 (3rd Cir. 1992).

<sup>56</sup> Bachrach, supra, note 51 at pp. 35-39; In re Glover Constr. Co., 30 B.R. 873 (Bankr. W.D. Ky. 1983); In re Ram Constr. Co., 32 B.R. 758 (Bankr. W.D. Pa. 1983).

<sup>57</sup> Fenton, Marc I., "Executory Contracts and the Role of the Surety," an unpublished article presented to the Fidelity and Surety Law Committee of the Tort and Insurance Practice Section of the American Bar Association on August 10, 1993.

construction contracts bonded by the surety.<sup>58</sup> The surety may be able to reduce its loss significantly if it has control over the ability of the principal/debtor to complete some or all of the principal/debtor's construction contracts. Without this control, the surety should seriously question whether it should finance the principal/debtor during its chapter 11 bankruptcy proceeding. The surety should argue to the Bankruptcy Court that its control over the bonded projects will reduce the surety's loss, thereby benefiting all of the pre-petition unsecured creditors of the principal/debtor. Furthermore, the principal/debtor must agree in the Bankruptcy Court order not to assume, assume and assign, or reject any of the bonded contracts without the express written permission of the surety.<sup>59</sup>

### 3. Section 362 of the Bankruptcy Code [11 U.S.C. § 362]

In order to assure the surety that it may exercise its rights under any Agreement, whether the Agreement is executed pre-petition or post-petition pursuant to Bankruptcy Court order, the principal/debtor should consent to providing the surety relief from the automatic stay provisions of section 362 of the Bankruptcy Code in order for the surety to exercise the following rights:

(a) All of the surety's rights against the bonded contract funds as provided in the Agreement, allowing their joint control in a Trust Account of the bonded contract funds, and the use of the bonded contract funds from the Trust Account;

(b) Authorize the surety to negotiate and settle all claims of subcontractors and suppliers against the payment bonds without subsequent Bankruptcy Court approval;

(c) Authorize the surety to use the Letters of Default and Termination as it deems necessary;

(d) Authorize the surety to begin negotiations and discussions with obligees and other contractors concerning the potential reletting and/or completion of the bonded contracts;<sup>60</sup> and

(e) Authorize the surety to exercise any other rights and take any other actions allowed under the Agreement.

## C. Summary

The rights described above should be secured by the surety before it agrees to finance the principal/debtor during its chapter 11 bankruptcy proceedings. The surety's goal is the same in any financing situation, namely taking such steps as are necessary to reduce its ultimate loss. The surety's financing of the principal outside of bankruptcy has been viewed as

<sup>58</sup> See the Financing and Collateral Agreement attached as Appendix A to this paper, Section 1, paragraph 5 at p. A-5 and Exhibit 4 to the Agreement at p. A-31.

<sup>59</sup> Shahinian and Clarke, *supra*. note 5 at p. 28.

<sup>60</sup> Frequently, sureties will obtain a letter of authority from the principal/debtor authorizing the surety to begin negotiations and discussions with any contractors, subcontractors, etc. that the surety deems appropriate for the purpose of reletting or otherwise satisfying the surety's obligations under its performance bond.

dangerous.<sup>61</sup> Outside of a bankruptcy proceeding, the surety may take actions that are stayed by the automatic stay of section 362 of the Bankruptcy Code once the principal/debtor files its chapter 11 bankruptcy proceeding. The rights described above and the providing of relief from the automatic stay will put the surety in the position of financing the principal/debtor under the same circumstances as if the chapter 11 bankruptcy proceeding had never been filed by the principal/debtor.

## **IX. RISKS TO THE SURETY BEYOND THE PENAL SUM OF THE PERFORMANCE BOND**

Absent the consent of the obligee, the primary disadvantage to the surety financing the principal is that the surety receives no credit against the penal sum of its performance bond, thereby risking a loss greater than the penal sum. Cases and commentaries have identified four additional risks to the surety financing the principal that may result in the surety's loss becoming greater than the penal sum of the performance bond.

### **A. Alter Ego**

The surety financing the principal pursuant to a financial arrangement such as the Agreement leads to a certain amount of control by the surety in the receipt of the bonded contract funds and the use of those bonded contract funds. Frequently, there are third-party creditors that are not protected by the surety's performance and payment bonds. These third-party creditors may allege that the surety so controlled the principal's business that the surety is the principal's alter ego and is liable for all of the principal's debts, whether incurred on a bonded contract or not. The more control exercised by the surety, the more likely it is that the principal's unpaid third-party creditors will attempt to treat the surety as the alter ego of the principal.

To date, third-party creditors suing the surety on an alter ego theory have been generally unsuccessful.<sup>62</sup> The McFadden case is particularly instructive. Many of the terms in the financing agreement utilized by the surety in the McFadden case<sup>63</sup> are similar to those provided in the Agreement attached as an Appendix to this paper. The court found that the surety did not take absolute and total control of the principal, but rather took steps to minimize its risk of loss as a major creditor of the principal.<sup>64</sup> Therefore, notwithstanding the control exercised by the surety, the third-party creditor not covered by the surety's performance and payment bonds was unable to collect its debt from the surety.

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<sup>61</sup> Schroeder No. 2, supra, note 1 at p. 1205.

<sup>62</sup> See James E. McFadden, Inc. v. Baltimore Contractors, Inc., 609 F. Supp 1102 (E.D. Pa. 1985); John G. Lambros Co. v. Aetna Cas. & Surety Co., 468 F. Supp. 624 (S.D.N.Y. 1979); Irvin & Leighton, Inc. v. W.M. Anderson Co., 532 A.2d 983 (Del. Ch. 1987). See also Schroeder No. 2, supra, note 1 at p. 1193-95.

<sup>63</sup> McFadden, supra, 609 F. Supp. at 1103-04.

<sup>64</sup> Id. at 1105.

## B. Domination

Similar to the alter ego theory, domination by the surety is normally alleged by the principal and the indemnitors either as the result of the failure of the financial arrangement to succeed in allowing the principal to remain in business, or as a result of the surety withdrawing its financial assistance under the Agreement when the surety deems it in its best interest to do so. At that point, the principal and the indemnitors may allege that the surety's control pursuant to the Agreement so dominated the principal's business management and affairs that it inhibited the principal's business from succeeding and forced the principal to go out of business. The major cases discussing domination are the Lambert cases, a series of cases where the principal and the indemnitors claimed that the surety so dominated the principal that the surety was liable to the principal and the indemnitors for damages.<sup>65</sup>

It is obvious that the surety financing the principal has an interest in the control of the bonded contract funds and their use under the Agreement in order to ensure that the surety's liabilities under the performance and payment bonds are met and that the surety's loss is minimized. To avoid a claim of domination, the surety must set forth clearly in the financing arrangement and the Agreement all of the surety's rights and the circumstances under which those rights may be exercised. Furthermore, the Agreement must contain a clear understanding that the obligations of the surety to finance the principal (and, if contemplated, to provide additional future bonds to the principal) are discretionary and the circumstances are clearly spelled out.<sup>66</sup>

## C. Tax Liabilities

By financing the principal, the surety will be directly liable for certain taxes of the principal as a result of the surety's payment of the wages of the principal's laborers on the bonded contracts. The surety's concern is whether it may become liable for additional unpaid taxes, including taxes not withheld by the principal on bonded or unbonded contracts prior to the initiation of the financing arrangements with the principal.<sup>67</sup>

<sup>65</sup> Lambert v. Maryland Casualty Co., 403 So. 2d 739 (La. App. 1981), aff'd, 418 So. 2d 553 (La. 1982). A discussion of the Lambert cases, including a chronological order by date of each decision, is contained in Schroeder No. 2, supra, note 1 at p. 1195-99. Other commentators on the Lambert cases include Joyce and Haug, supra, note 1 at p. 34, n.14, and Sneed, William R. and Athay, Michael, "Ramifications for the Surety--Domination Revisited," an unpublished article presented to the Fidelity and Surety Law Committee of the Tort and Insurance Practice Section of the American Bar Association on January 29, 1988.

<sup>66</sup> See the Financing and Collateral Agreement attached as an Appendix to this paper, Section V, Miscellaneous Provisions, paragraph 3 at p. A-20 (providing financial assistance to the principal) and paragraph 4 at p. A-21 (providing future bonds to the principal). With respect to the issue of a surety's refusal to provide financial assistance to its principal, see generally Haug, William F., "Financing Your 'Solvent' Principal-Success or Failure," an unpublished article presented to the Fidelity and Surety Law Committee of the Tort and Insurance Practice Section of the American Bar Association on January 26, 1996, pp. 6-9. With respect to the issue of a surety's refusal to provide future bonds to its principal, see Arntz Contracting Co. v. St. Paul Fire and Marine Ins. Co., 47 Cal. App. 4th 464, 54 Cal. Rptr. 2d 888 (1996) (an anomalous case where the principal was awarded damages against the surety for the surety's alleged breach of an oral promise to continue bonding for a principal default terminated on a bonded contract, and based on California's liberal parole evidence rule).

<sup>67</sup> This paper does not discuss the conflict between the surety and the federal government or any other taxing authority under either of the following scenarios:

- (1) The right of the government as obligee to set off against bonded contract funds for obligations such as unpaid taxes owed to the government obligee by the principal; and
- (2) The right of the government taxing authority when it is not the obligee (and therefore has no setoff rights) to assert a tax lien against the bonded contract funds.

These issues are more fully discussed in The Law of Suretyship, 2nd Ed., Chapter 23 (Edward G. Gallagher ed., 2000) entitled "The Surety's Subrogation Rights," by George J. Bachrach and John V. Burch, section V.B.1. (surety v. obligee) and section V.B.6.

There have been a number of commentators who have discussed the surety's potential tax liabilities in financing the principal.<sup>68</sup> The surety may be liable for withheld taxes under the performance bond itself. For any Federal Government projects bid after July 15, 1967, the Miller Act performance bond provides that the surety is liable for withholding taxes.<sup>69</sup> Furthermore, performance bonds executed pursuant to the Little Miller Acts of various States or on private contracts may create liability for the surety when the principal is obligated under the contract to pay withholding taxes. Finally, the Internal Revenue Code creates potential new liability for the surety financing its principal in three instances:

1. Section 3401 [26 U.S.C. § 3401]

The surety may be liable for withholding taxes as the “employer” when it has exercised exclusive control over the principal’s employees and the payment of wages to those employees.

2. Section 3505 [26 U.S.C. § 3505]

The surety is liable for withholding taxes when it directly pays the wages of its principal’s laborers, or, in the alternative, when the surety indirectly funds the payments of those wages knowing that the principal will not withhold and pay over the necessary payroll taxes. In this latter situation, the surety that finances the principal, including the funding of the principal’s payroll, and has notice or reasonably believes that the principal does not intend to make timely deposits of withholding taxes, is liable to the United States for taxes and interest totaling up to 25% of the advances made. Section 3505 liability appears to be unavoidable by the financing surety.<sup>70</sup>

3. Section 6672 [26 U.S.C. § 6672]

The surety financing the principal and collecting the bonded contract funds may be deemed to be a “responsible person” for the payment of all of the taxes that were to be withheld by the principal, and the surety’s “willful” failure to pay the withheld taxes as a “responsible person” may subject the surety to liability beyond the amounts withheld for the principal’s laborers on the bonded contracts.<sup>71</sup>

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(surety v. taxing authorities other than the obligee) and The Law of Suretyship, Chapter 26 (Edward G. Gallagher ed., 1993) entitled “The Surety’s Subrogation Rights,” by George J. Bachrach and John V. Burch, section V.B.1. (surety v. obligee) and section V.B.6. (surety v. taxing authorities other than the obligee).

<sup>68</sup> Ferrucci, James D., “Avoiding IRS Pitfalls When Financing the Principal,” an unpublished article presented to the Northeast Surety and Fidelity Claims Conference on October 21, 1999 (and reprinted in September, 2000); Joyce and Haug, supra, note 1 at p. 26; Schroeder No. 1, supra, note 1 at p. 857-59; Mrozek, Donald, “The Surety’s Responsibility for Withholding Taxes,” an unpublished article presented to the Fidelity and Surety Law Committee of the Section of Insurance, Negligence and Compensation Law of the American Bar Association on January 27, 1978.

<sup>69</sup> 40 U.S.C. § 270a(d) [“Every performance bond required under this section (the Miller Act) shall specifically provide coverage for taxes imposed by the United States which are collected, deducted, or withheld from wages paid by the contractor in carrying out the contract with respect to which such bond is furnished.”]

<sup>70</sup> See Schroeder No. 1, supra, note 1 at p. 858; Joyce and Haug, supra, note 1 at p. 26.

<sup>71</sup> See Anderson v. United States, 561 F.2d 162 (8th Cir. 1977); Schroeder No. 2, supra, note 1 at p. 1199-1200.

In order to protect the surety from the tax liabilities of section 3505, the Agreement attached to the Appendix for this paper contains a specific provision for the payment by the surety and the principal of all withholding and payroll taxes.<sup>72</sup> Furthermore, at the time the tax payments are made by the surety and the principal, the surety must file Form 4219 with the Internal Revenue Service.<sup>73</sup>

#### **D. Environmental Claims**

Financing the principal may expose the surety to potential liability for clean up costs for hazardous wastes pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act<sup>74</sup> (“CERCLA”) and other state hazardous waste laws. Several recent articles have discussed this potential liability.<sup>75</sup> Two major issues are involved. The first is the surety’s potential liability in actually financing the principal. The second is the surety’s potential liability in obtaining collateral security containing hazardous wastes.

##### **1. The Surety’s “Capacity to Influence” the Principal**

Pursuant to the surety’s financial arrangements and the Agreement with the principal, the surety may have the “capacity to influence” the principal’s decisions on a day-to-day basis, including its decisions on hazardous wastes.<sup>76</sup> The surety’s potential liability in financing the principal may be as an “operator” of a “facility” or as an “arranger” for the disposal of hazardous wastes, and may arise in several ways:

(a) The surety’s control over the collection and use of the bonded contract funds pursuant to the Agreement; and

(b) The surety’s potential “capacity to influence” through its participation in the principal’s management decisions on day-to-day issues (overhead expenses, sale of excess equipment and inventory, access to books and records and the bonded project sites, etc.).<sup>77</sup>

<sup>72</sup> See the Financing and Collateral Agreement, Section III, paragraph 4(h) at p. A-14 [“Payment of all withholding and payroll taxes and other amounts deducted from employee wages from the Contracts bonded by the Surety for the Principal from the date of this Agreement forward shall be made on a priority basis directly from the Trust Account to the appropriate payee(s) for all withholding and payroll taxes and other normal payroll burden expenses.”]

<sup>73</sup> Form 4219, Statement of Liability of Lender, Surety, or Other Person for Withholding Taxes under Section 3505 of the Internal Revenue Code.

<sup>74</sup> 42 U.S.C. § 9601.

<sup>75</sup> Welge, Mark A., “Environmental Concerns of the Surety Seeking Salvage,” Chapter 6 of Salvage by the Surety (George J. Bachrach ed., 1998); Wright, Robert M. and Ryan, William F., Jr., “Hazardous Waste Liability and the Surety Revisited,” 30 Tort and Insurance Law Journal 741 (1995) (hereinafter referred to as Wright); and Ryan, William F., Jr., and Wright, Robert M., “Hazardous Waste Liability and the Surety,” 25 Tort and Insurance Law Journal 663 (1990).

<sup>76</sup> Wright, *supra*. note 75 at p. 756; United States v. Fleet Factors Corp., 901 F.2d 1550, 1557 (11th Cir. 1990), *cert. denied*, 111 S. Ct. 752 (1991) [“a secured creditor may incur (Superfund cleanup) liability, without being an operator, by participating in the financial management of a facility to a degree indicating a capacity to influence the (borrower) corporation’s treatment of hazardous wastes.”]

<sup>77</sup> As stated in Fleet Factors, “a secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose.” 901 F.2d at 1557-58. Other circuits require actual participation in the management of a facility before liability will be found. United States v. McLamb, 5 F.3d 69 (4th Cir. 1993); In re Bergsoe Metal, 910 F.2d 668 (9th Cir. 1990).

While the Fleet Factors case dealt with a secured lending bank, and is applicable to the Eleventh Circuit only, it does raise certain questions concerning the potential liability of the surety financing the principal under CERCLA and other hazardous waste liability laws. There are cases where the surety has not been held liable to third parties when such a financing arrangement exists.<sup>78</sup> However:

There is little doubt that under the agreements used by the surety in McFadden as well as the terms and conditions of most agreements used by sureties who are financing their principal, the surety does have the “capacity to influence” the principal’s activities, both by way of its control over the funding of its principal’s overhead expenses and field expenses, as well as its control over cash infusion and cash flow from the bonded and perhaps unbonded projects.<sup>79</sup>

While other decisions are more restrictive,<sup>80</sup> and Congress and the Environmental Protection Agency are reviewing ways to minimize the effect of the Fleet Factors decision, the potential liability of the surety financing its principal under the theories espoused in Fleet Factors remains a risk to the surety.

## 2. Collateral Security Containing Hazardous Wastes

In making the decision to finance the principal, the surety frequently takes collateral security, including mortgages on real property. CERCLA and other hazardous waste laws may have an effect on the collateral security taken by the surety, including:

(a) The collateral security forming a part of the basis for the surety’s financing of the principal may require hazardous waste clean up that diminishes the value of the collateral security or subjects the collateral security to a superseding governmental lien for the cost of the hazardous waste cleanup;

(b) The impact of any hazardous waste cleanup costs funded by the principal may greatly impact on the principal’s ability to repay the surety for the loans and advances the surety has made under the financing arrangements; and

(c) The surety foreclosing on its collateral security after the principal’s and the indemnitor’s default may result in the surety becoming an owner/operator/arranger and subject to hazardous waste cleanup costs.

## 3. Summary

The potential risk to the surety for environmental and hazardous waste claims remains a strong factor in determining whether the surety should finance the principal. The

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<sup>78</sup> James E. McFadden & Co. v. Baltimore Contractors, Inc., 609 F. Supp. 1102 (E.D. Pa. 1985).

<sup>79</sup> Wright, *supra*. note 75 at p. 757.

<sup>80</sup> See note 77, supra.

surety may face similar risks regardless of what performance bond option the surety chooses (including takeover and tender).<sup>81</sup> This is an area of the law that may remain uncertain for a long period of time.

## **X. SUBROGATION RIGHTS OF THE SURETY FINANCING THE PRINCIPAL**

All of the rights discussed so far in this paper have been contract rights. The principal enters into a construction contract with the obligee, subcontracts with its subcontractors, and purchase orders with its suppliers. The principal and the surety execute the performance and payment bonds on behalf of the obligee. The principal and the indemnitors execute the agreement of indemnity in favor of the surety. When the surety finances the principal, the principal and the indemnitors execute the Agreement and any liens, security agreements and financing statements with respect to the collateral security. When disputes arise among the various parties, they are resolved by reference to the existing contracts.

Subrogation is a basic right of the surety arising not by way of a written contract, but by operation of law and equity. The surety's subrogation rights are a creation of the courts, which have ruled that a surety that pays or otherwise performs its obligations under its bonds may step into the shoes of those persons to whom or on whose behalf the surety has performed or made payment. As a result, the surety may enforce the rights of those persons who have received payment or the benefit of the surety's performance against the rights of other parties in order for the surety to obtain reimbursement for its losses. There are many primary and secondary research sources and commentaries on the surety's subrogation rights.<sup>82</sup>

There are four essential elements necessary for a surety to successfully assert its subrogation rights<sup>83</sup>:

- (1) An obligation of the principal to the obligee;
- (2) Failure of the principal to perform that obligation;
- (3) Rights of the obligee arising from the principal's failure to perform; and
- (4) The performance by the surety, pursuant to the suretyship, of the obligation that the principal failed to perform.

When the above four elements exist, the surety is substituted for the obligee with respect to the rights which the obligee has against the principal as a result of the principal's failure to perform.

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<sup>81</sup> Wright, supra. note 75.

<sup>82</sup> Bachrach, George J. and Rodgers-Waire, Cynthia E., "The Surety's Rights to the Contract Funds in the Principal's Chapter 11 Bankruptcy Case," 35 Tort and Insurance Law Journal 1 (1999); The Subrogation Database: Cases Concerning the Subrogation Rights of the Contract Bond Surety (George J. Bachrach ed., 1995); The Law of Suretyship, 2nd Ed., Chapter 23 (Edward G. Gallagher ed., 2000) entitled "The Surety's Subrogation Rights," by George J. Bachrach and John V. Burch; The Law of Suretyship, Chapter 26 (Edward G. Gallagher ed., 1993) entitled "The Surety's Subrogation Rights" by George J. Bachrach and John V. Burch; Subrogation Rights of the Contract Bond Surety (George J. Bachrach ed., 1990) (papers presented at the Annual Meeting of the Fidelity and Surety Law Committee of the Tort and Insurance Practice Section of the American Bar Association on August 7, 1990).

<sup>83</sup> Mungall, Daniel, Jr., "The Subrogation Rights of the Contract Bond Surety: Some Basics," contained in the Subrogation Rights of the Contract Bond Surety (George J. Bachrach ed., 1990). See also Restatement (Third) of Suretyship and Guaranty (1995), §§ 27-31.

Other commentators on the surety financing the principal have briefly discussed the surety's subrogation rights.<sup>84</sup> The law with respect to the subrogation rights of the surety financing the principal is as follows:

(1) The surety financing the principal is acting in accordance with its legal obligations under its performance bond and therefore has the rights of a performance bond surety;<sup>85</sup> and

(2) The surety financing the principal is not a volunteer lending money to the principal outside of the scope of its performance bond.<sup>86</sup>

In summary, the surety financing the principal is acting as a performance bond surety, and may exercise all of its subrogation rights as a performance bond surety to seek reimbursement to reduce its loss.<sup>87</sup>

## XI. CONCLUSION

Financing the principal may be a dangerous course of action.<sup>88</sup> However, the surety may decide to finance the principal because it believes that financing is the cheapest way to get the bonded contracts done. That belief is predicated upon the surety's investigation and its analysis of the information collected. For the surety to consider financing the principal as a performance bond option, the surety must reach the conclusions that there is nothing wrong with the principal that money cannot cure, and that the capacity, character and collateral of the principal and the indemnitors appear favorable.

The surety should not minimize its substantial financial and management involvement with the principal in an ongoing financing arrangement. From a financial point of view, the surety will frequently pay the principal's debts that are not covered by either the performance or payment bond, including the principal's overhead. From a management point of view, there will be daily and weekly involvement by the surety in the principal's decisions on the bonded contracts. To the extent that consultants, attorneys and accountants are necessary, the surety will incur costs and expenses in this management function.

Finally, it is critical that the financing agreement between and among the surety, the principal and the indemnitors is clear and unambiguous as to the rights and obligations of the

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<sup>84</sup> Joyce and Haug, *supra*. note 1 at p. 36-37; Schroeder No. 1, *supra*. note 1 at p. 861-63.

<sup>85</sup> Aetna Cas. and Sur. Co. v. United States, 845 F.2d 971 (Fed. Cir. 1988); Morrison Assurance Co., Inc. v. United States, 3 Cl. Ct. 626 (1983); Great American Ins. Co. v. United States, 481 F.2d 1298, 1300 n.8 (Ct. Cl. 1973); Morganthau v. Fidelity & Deposit Co. of Md., 94 F.2d 632 (D.C. Cir. 1937).

<sup>86</sup> Indemnity Ins. Co. of North Am. v. Lane Contracting Corp., 227 F. Supp. 143 (D. Neb. 1964).

<sup>87</sup> Bachrach, George J. and Rodgers-Waire, Cynthia E., "The Surety's Rights to the Contract Funds in the Principal's Chapter 11 Bankruptcy Case," 35 Tort and Insurance Law Journal 1 (1999); The Subrogation Database: Cases Concerning the Subrogation Rights of the Contract Bond Surety (George J. Bachrach ed., 1995). The Subrogation Database contains all of the cases concerning the subrogation rights of the contract bond surety organized in an Outline (Matrix) form. The Outline (Matrix) lists the significant issues concerning the subrogation rights of the contract bond surety and provides a framework or structure to identify, organize and categorize all cases concerning the surety's subrogation rights. The Subrogation Database contains in excess of 700 cases.

<sup>88</sup> See note 1, supra.

parties. All issues and potential disputes should be discussed and resolved. It is far better to have the negotiations over the financing agreement fall apart at an early stage before the surety commits to financing the principal for any period of time rather than to create and execute a financing agreement that is unclear and ambiguous. The financing agreement should be as detailed as possible, and attempt to resolve anticipated issues as well as those already known and outstanding.<sup>89</sup>

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<sup>89</sup> “Whether the financing program works depends largely upon tangible factors over which the surety has little control. But whether it works or not, if the financing program was intelligently thought through from the beginning, and the results of that analysis were appropriately documented, the surety will at least find itself in the best available position under the circumstances.” Schroeder No. 2, supra. note 1 at p. 1214.

## **ACKNOWLEDGMENT**

The author of this paper wishes to acknowledge that, in addition to my own thoughts, I have liberally stolen material from many prior authors on the subject of surety financing of the principal. These prior authors and their works are listed in the footnotes and in the Selected Readings on Surety Financing of the Principal attached to this paper. Without their leads and prior efforts, this paper would have been much more difficult to create. With the wealth of talent before me, there was no sense in completely reinventing the wheel.

Where my thefts have been so blatant and egregious that they cannot possibly be covered up, I have given appropriate credit in the footnotes.

## SELECTED READINGS ON SURETY FINANCING OF THE PRINCIPAL

### Books

The Law of Suretyship, 2nd Ed., Chapter 6 entitled "Contract Performance Bonds" by Marilyn Klinger, James P. Diwik and Kevin L. Lybeck (Edward G. Gallagher ed., 2000).

The Law of Performance Bonds, Chapter 3 entitled "Rights of Surety in Event of Default" by James J. Mercier and John T. Harris (Lawrence R. Moelmann and John T. Harris eds., 2000).

Bond Default Manual, 2nd Ed., Chapter 4 entitled "Financing the Principal" by George J. Bachrach (Duncan L. Clore ed., 1995).

The Law of Suretyship, Chapter 7 entitled "The Contract Performance Bond" by Marilyn Klinger and James P. Diwik (Edward G. Gallagher ed., 1993).

Contract Surety (AFSB 152), Chapters 12 and 13 entitled "Contract Surety Claims" by Stephen J. Trecker and George J. Bachrach (The American Institute for Chartered Property Casualty Underwriters and the Insurance Institute of America 1992).

Bond Default Manual, Chapter 2 entitled "Financing the Contractor" by Thomas A. Joyce and William F. Haug (R. Wisner ed., 1987).

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- Sneed, William R. and Athay, Michael, "Ramifications for the Surety--Domination Revisited," an unpublished article presented to the Fidelity and Surety Law Committee of the Tort and Insurance Practice Section of the American Bar Association on January 29, 1988.
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- Welge, Mark A., "Environmental Contamination by the Surety See (Environmental Contamination by the Surety) Chapter 6198).
- Wright, Robert M. and Ryan, William F., Jr., "Hazardous Waste Liability and the Surety Revisited." 30 Tort and Insurance Law Journal 741 (1995).

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Mr. Bachrach has written and spoken extensively on many issues involving the surety, including:

### A. Subrogation Rights of the Contract Bond Surety

Co-author (with John V. Burch), "The Surety's Subrogation Rights," Chapter 23 of The Law of Suretyship, 2nd Ed. (Edward G. Gallagher, ed.), Tort and Insurance Practice Section – American Bar Association (2000).

Editor, The Subrogation Database: Cases Concerning the Subrogation Rights of the Contract Bond Surety, Tort and Insurance Practice Section - American Bar Association (1995), updated on January 31, 1998.

Co-author (with John V. Burch), "The Surety's Subrogation Rights," Chapter 26 of The Law of Suretyship (Edward G. Gallagher, ed.), Tort and Insurance Practice Section - American Bar Association (1993).

Editor, Subrogation Rights of the Contract Bond Surety, Tort and Insurance Practice Section - American Bar Association (1990).

Chair and Moderator of the Surety Program entitled "The Subrogation Rights of the Contract Bond Surety" which was presented at the Annual Meeting of the Fidelity and Surety Law Committee, Tort and Insurance Practice Section - American Bar Association (August 7, 1990).

Author, "Introduction to the Subrogation Rights of the Contract Bond Surety and the Computer Database of Contract Bond Surety Subrogation Cases," an unpublished article presented to the Fidelity and Surety Law Committee, Tort and Insurance Practice Section - American Bar Association ( August 7, 1990).

### B. The Agreement of Indemnity

Editor, The Agreement of Indemnity: Practical Applications by the Surety, Tort and Insurance Practice Section - American Bar Association (1989).

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Insurance Practice Section - American Bar Association (January 27, 1989).

Co-author (with Robert L. Lawrence, Robert M. Wright and William M. Dolan, III), "The Agreement of Indemnity - The Surety's Handling of Contract Bond Problems: The Enforcement of the Surety's Rights Against the Principal and the Indemnitors Under the Agreement of Indemnity," an unpublished article presented to the Fidelity and Surety Law Committee, Tort and Insurance Practice Section - American Bar Association (January 27, 1989).

C. Salvage by the Surety

Editor, Salvage by the Surety, Tort and Insurance Practice Section - American Bar Association (1998).

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Author, "The Surety's Rights to Obtain Salvage - Exoneration, Reimbursement, Subrogation, and Contribution," an article presented to the Fidelity and Surety Law Committee, Tort and Insurance Practice Section - American Bar Association (August 3, 1997).

D. Surety/Bankruptcy Issues

Co-author (with Cynthia E. Rodgers-Waire), "The Surety's Rights to the Contract Funds in the Principal's Chapter 11 Bankruptcy Case," 35 Tort and Insurance Law Journal 1 (1999).

E. Other Publications on Surety Matters

Co-author (with Robert F. Carney), "The Surety and the Court of Federal Claims," an unpublished article presented to the Surety Claims Institute in Williamsburg, Virginia (June 22, 1995); and "The Surety and the Court of Federal Claims - Revisited," an unpublished article presented at the Tenth Annual Northeast Surety and Fidelity Claims Conference (October 21, 1999).

Author, "Financing the Principal," Chapter 4 of the Bond Default Manual, 2nd Ed. (Duncan L. Clore, ed.), Tort and Insurance Practice Section - American Bar Association (1995).

Author, "Customs Bonds and the Chapter 11 Principal," an unpublished article presented to the International Association of Defense Counsel on January 29, 1994.

Co-author (with Stephen J. Trecker), Contract Surety (AFSB 152), Chapters 12 and 13 entitled "Contract Surety Claims" for the American Institute for

Chartered Property Casualty Underwriters and the Insurance Institute of American (1992).

Mr. Bachrach has been a member of the Fidelity and Surety Law Committee of the Tort & Insurance Practice Section of the American Bar Association since 1978, serving as a Vice-Chair from 1990 to 1996 and from 1997 to the present. He has been the Co-Chair of the Law Division of the Fidelity and Surety Law Committee since 1996, and is the former Co-Chair of the Law Division Subcommittee on Indemnity, Salvage and Subrogation Law. Mr. Bachrach will become the Chair of the Fidelity and Surety Law Committee for the one year period beginning after the August, 2001 Annual Meeting of the American Bar Association.

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