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CONFERENCE**

**FINANCING OR EXTENDING SURETY CREDIT TO THE
INSOLVENT PRINCIPAL – BANKRUPTCY ISSUES,
STRATEGIES, AND THE FINANCING ORDER**

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**Final Order Authorizing the Turnover of Construction Trust Funds,
the Use of Trust Property, the Extension of Post-Petition Secured
Credit, the Granting of a Super-Priority Lien, and for Other Relief**

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FINANCING OR EXTENDING SURETY CREDIT TO THE INSOLVENT PRINCIPAL – BANKRUPTCY ISSUES, STRATEGIES AND THE FINANCING ORDER

I. INTRODUCTION:

When a contract surety's bonded principal encounters financial difficulty, the surety is often faced with the prospect of imminent defaults on numerous bonded contracts and the difficult task of ascertaining the most efficient and least costly method of minimizing the surety's exposure and maximizing its recovery prospects. Possible responses by the surety to its performance bond obligations can include reprocurement through takeover and completion agreements or the tendering of third-party completion contractors to the obligees while financing the shortfall between the remaining contract balances and the bids of the tendered contractors. Alternatively, the surety may determine that it has a legitimate basis to disclaim under some of its bonds, or it may succeed in negotiating lump sum settlements or buy-outs of some of its performance bond obligations.

In certain circumstances, however, a surety may determine that it is in its best interests to allow its principal to continue with the performance of some or all of the bonded contracts with the surety's economic support. While this option is inherently risky and is not recommended as a uniform response to performance defaults, there are instances in which such option offers the best opportunity to mitigate damages. Other papers in this program have reviewed the issues which should be considered before loaning funds or otherwise financing a principal and the various types of financing agreements which may be utilized to minimize the surety's financing risks and to maximize the possibility of recovery with respect to the surety credit extended. This paper will provide an overview of bankruptcy issues to be considered when financing an insolvent or potentially insolvent principal and will review provisions of a construction trust fund and financing type order which should be obtained before extending surety credit to a bankrupt principal. This paper is not intended to review all of the bankruptcy issues faced by a financing surety; nor is it intended to present a scholarly analysis of the Bankruptcy Code and its impact on sureties. Such issues have been addressed in many other papers. A bibliography of some of those papers is attached as recommended reading.

II. FINANCING CONSIDERATIONS.

As will be reviewed by others, the surety's financing option poses substantial risks, as a failing contractor's operations are often plagued by mismanagement and inefficiency. In such circumstances, the unwary surety can find itself pouring money into a "black hole," rueing the day it was persuaded to finance its troubled principal.

Those instances where the extension of surety credit may be considered the most efficient response to a principal's prospective default, however, include situations in which the bonded contracts are nearly complete and can be wrapped up in a limited period of time, whereas resorting to third party completion contractors will result in substantial demobilization and remobilization costs, significant delays, and increased consequential damage exposure.

Other situations justifying consideration of surety financing are where the surety has concluded that its principal is an effective, reasonably efficient and well managed entity capable of competing effectively in the construction marketplace, but has found itself in need of additional financial support due to circumstances largely beyond its control. Such circumstances might include, for example, financial reversals caused by the principal's failure to have collected substantial accounts receivable on an unbonded job due to the owner's own bankruptcy; or where the principal's working capital has been depleted on a job on which it might have legitimate claims which may require protracted litigation to recover. Alternatively, the surety may simply conclude that the principal underbid its work or otherwise is incapable of completing performance without the surety's economic support, but it remains the most capable or efficient contractor under the circumstances to complete the bonded work.

Once the surety has determined that financing its principal is an attractive option, it must take measures to assure itself that such financing effectively serves to mitigate its damage exposure under its bonds. In this regard, the surety's counsel must have a firm grasp of potential bankruptcy pitfalls, because, by definition, the surety is financing a principal which is unable to meet its obligations as they come due. As this fact alone meets one of the definitions of insolvency, bankruptcy is almost always a possibility, if not a probability.

A. THE BANKRUPTCY CODE'S PREFERENCE PROVISIONS AND THE SURETY.

1. Bankruptcy Code Section 547.

Amongst the bankruptcy pitfalls of which a surety must be aware in dealing with a financially troubled principal is Section 547 of the Bankruptcy Code, which allows a debtor or trustee in bankruptcy to recoup payments made by the debtor within 90 days of a bankruptcy filing where such payments were made in satisfaction of an antecedent debt. Where the preferential transfer has been made by the debtor to or on behalf of an "insider" of the debtor, the preference period extends back one year prior to the bankruptcy filing. An "insider" is defined in Section 101(31) to include, among others, relatives or partners of the debtor, if the debtor is an individual, and officers, directors, persons in control, and their relatives if the debtor is a corporation.

Therefore, for example, payments made by a bonded contractor to subcontractors and materialmen within 90 days of the filing of its petition in bankruptcy for services previously rendered, billed, and due, as opposed to current payments for current services, may be capable of being voided and the subcontractor or materialman receiving such payment may be compelled to disgorge them to the debtor-in-possession or its trustee. As a result, where a debtor-in-possession or trustee seeks to recover a payment made to a subcontractor or materialman within 90 days of the bankruptcy filing on the basis that such transfer was preferential, such recovery, if successful, would likely create a payment bond claim against the surety. Should this occur in a situation where the surety has been providing financing to a principal, in order to allow such principal to continue performance of bonded work and pay subcontractors and materialmen, the surety might find itself in the anomalous position of paying claims twice, once indirectly and once directly.

Where no protections have been built into the financing agreements against such preferential transfer exposure, the surety will be left to argue that the payments made by its principal to the subcontractor or materialman meet one of several statutory exceptions. Such payment may have been made in the ordinary course of business and therefore would not be voidable under Section 547(c)(2) of the Bankruptcy Code, or there may have been a contemporaneous exchange for value under Section 547(c)(1). In the alternative, the subcontractor or materialman may have contributed new value after receipt of the payment under Section 547(c)(4).

The ordinary course of business defense would require an analysis of the payment history between the principal and the claimant. For example, if the principal had for years made payments 60 days after receipt of materials and continued that pattern into the preference period, such payments, even though made on account of an antecedent debt, arguably would not be voidable based upon the ordinary course of business exception.

Arguments to be advanced by the surety focusing on a contemporaneous exchange of value defense might include a contemporaneous agreement between the bonded contractor and its subcontractor or materialman for such subcontractor or materialman to continue working on a project or to continue supplying materials in exchange for payment of the antecedent debt. A second possible basis for urging applicability of this defense is to assert that the surety has provided a contemporaneous exchange of value to the debtor by effectively releasing its equitable lien on the unpaid contract funds held by the owner by permitting continued payment by the owner to the principal of the contract funds during the preference period. Such an argument was accepted by the U.S. Court of Appeals for the Ninth Circuit in In re E.R. Fegert, Inc., 88 B.R. 258 (B.A.P. 9th Cir. 1988), aff'd, 887 F.2d 955 (9th Cir. 1989). The extent to which this argument will succeed, however, is limited to the amount of contract proceeds then subject to the surety's equitable lien. Moreover, there is some split of authority regarding the efficacy of this argument. See generally, T. Scott Leo and Gary A. Wilson, Suretyship and the Bankruptcy Code, in THE LAW OF SURETYSHIP, 9-1, 9-4 (Edward G. Gallagher ed., 1993).

One potential pitfall arises because the surety's equitable lien has been said not to arise until such time as it has made a payment under its bond. Thus, at the time of the preferential payment by the principal, no lien rights may have existed which could be deemed waived by the surety to provide a contemporaneous exchange of value.

2. Use of Construction Trust Fund Statutes and Trust Agreements to Avoid Preference Provisions and Protect the Surety.

Another argument which might be raised by the surety to defeat the debtor's attempt to recoup preferential payments made to subcontractors and material suppliers is to assert the applicability of either a construction trust fund statute or a trust fund clause in an agreement of indemnity executed by the principal.

The requirement that a debtor recognize and honor its construction trust fund obligations was established by the United States Court of Appeals for the Third Circuit in

Universal Bonding Insurance Co. v. Gittens and Sprinkle Enterprises, Inc., 960 F.2d 366 (3d Cir. 1992) which recognized that where contract proceeds are subject to statutory construction trust fund provisions, even where the debtor is entitled to the receipt of such funds, they must continue to be held in trust for the benefit of subcontractors and materialmen. Thus, even if a debtor were to assert that a preferential payment to a subcontractor or materialman is voidable, if such payment is made from trust funds, the filing of a bankruptcy petition will not void the trust and the surety's interests may be protected by invoking any applicable construction trust fund statute. See Cooper v. Grisofe Electric Corp. (In re Building Dynamics, Inc.), 134 B.R. 715 (Bankr. W.D.N.Y. 1992).

Where a construction trust fund statute is not available, review of the principal's indemnity agreement may reveal a contractual commitment on the part of the principal to treat bonded contract receivables as trust funds and, therefore, not as property of the debtor estate in the absence of its satisfaction of the proper claims of subcontractors and materialmen. The Bankruptcy Code recognizes that funds held in trust are generally not property of the debtor estate. 11 U.S.C. § 541(d); Begier v. Internal Revenue Serv., 496 U.S. 53, 59 (1990) ("Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not 'property of the estate.'"); In re California Trade Technical Schools, Inc., 923 F.2d 641 (9th Cir. 1991). Moreover, at least one bankruptcy court has expressly acknowledged that construction contract funds may be subject to a trust whereby "the subcontractors and suppliers would own beneficial title to a portion of the trust fund, and the contractor would hold legal title to those funds as trustee." In re Glover Constr. Co., 30 B.R. 873, 880 (Bankr. W.D. Ky. 1983) (Glover I). In Glover I, the court also recognized that trust fund rights may arise under an express trust created by the parties to the construction contract or by an express trust created under the terms of an indemnity agreement. Id. at 880 n.22; see also In re RAM Constr. Co., 32 B.R. 758, 760 (Bankr. W.D. Pa. 1982); In re Pacific Marine Dredging and Constr., 79 B.R. 924, 928 (Bankr. D. Or. 1987); In re Alliance Props., Inc., 104 B.R. 306, 312 (Bankr. S.D. Cal. 1989); In re Western Urethanes, Inc., 61 B.R. 243, 247 (Bankr. D. Colo. 1986) ("Had the [surety] sought the protection of a trust, it could have been provided for in the [indemnity] agreement."); In re Alcon Demolition, Inc., 204 B.R. 440 (Bankr. D.N.J. 1997) (indemnity agreement created enforceable trust in favor of surety).

Whether a trust exists is a question to be decided under state law. In re B.I. Fin. Servs. Group, Inc., 854 F.2d 351, 354 (9th Cir. 1988); see Elliot v. Bumb, 356 F.2d 749, 753 (9th Cir. 1966), cert. denied, 385 U.S. 829 (1966). If there is a valid trust in existence, "property the debtor held in trust at the time of filing its bankruptcy petition is excluded from the bankruptcy estate." Id., (citing United States v. Whiting Pools, Inc., 462 U.S. 198, 205 n.10 (1983)); see also In re Columbia Gas Systems, Inc., 997 F.2d 1039, 1059 (3d Cir. 1993) (holding that Congress clearly intended the exclusion to include not only funds held in express trust, but also funds held in constructive trust).

The relationship created by the trust fund provision contained in many indemnity agreements can create substantial leverage for the surety. Such leverage is illustrated in the case of Matter of Jenkins, 110 B.R. 74 (Bankr. M.D. Fla. 1990). There the court considered a trust fund provision in an agreement of indemnity which provided as follows:

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

Id. at 76.

The Jenkins court addressed whether the debtor's failure to comply with this trust fund provision by diverting certain contract funds created a nondischargeable debt under Section 523 (a)(4) of the Bankruptcy Code. That section makes a debt nondischargeable if incurred as a result of fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny. The court considered whether the trust fund provision of the agreement of indemnity created a fiduciary relationship and found:

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

Id.

Needless to say, when the surety is dealing with a debtor-in-possession remaining under the control of the officers and directors charged with fulfilling the fiduciary obligations of the corporation, the possibility that the surety's success in voiding a preferential transfer will create a nondischargeable debt which they will be called upon to satisfy personally, is a tremendous bargaining chip in the hands of the surety in resolving any contested issues relating to preferential transfers. The reality, however, generally is that such issues would only come into play where a trustee has been appointed who is not inhibited in the pursuit of preferential transfers by any personal concerns such as the protection of the interests of the prior officers of the debtor. Nonetheless, even if a trustee is involved, if the funds which were the subject of the preferential transfer are traceable and can be demonstrated to be trust funds, the trustee also will have no interest in seeking the recovery of such preferential transfers, because the recovery effected would be recovered into a trust which would not provide any greater benefit to the debtor estate.

3. The Earmarking Doctrine.

Another basis for avoiding a preferential transfer claim is the "earmarking doctrine." This doctrine is summarized in Sierra Steel, Inc. v. S & S Steel Fabrication, 96 B.R. 271, 274 (B.A.P. 9th Cir. 1989), as follows: "Under the earmarking doctrine, when a third party advances or loans funds to the debtor with instructions to use the funds to pay off another creditor, the

funds are said to be earmarked for payment to a specific creditor or creditors and do not become property of the debtor.” See generally, Chad L. Shexnayder, Bankruptcy and the Surety, in THE LAW OF SURETYSHIP, 317, 360-61 (Edward G. Gallagher 2d ed., 2000).

In drafting financing agreements, therefore, it is useful to include in such agreements provisions earmarking the proceeds of loans received from the surety as being trust funds. The agreement should expressly designate the principal and its officers as trustees establishing a fiduciary relationship regarding such loan proceeds. This should reduce the risk that payments to subcontractors and materialmen made from such loan proceeds may be recouped by a trustee in bankruptcy and diverted to finance expenses of administration which might be of no benefit to the surety.

Where the surety intends to allow its principal to continue to collect accounts receivable on bonded projects, another means of augmenting the surety’s ability to avoid preferential transfer claims of the bankruptcy trustee is to include within the financing agreement a clause providing that the proceeds of all such collections constitute trust funds.

III. OBTAINING ADDITIONAL COLLATERAL FROM THE PRINCIPAL AND INDEMNITORS.

Generally speaking, when a surety considers the possibility of financing its principal, it will seek to obtain some additional form of collateral to secure the repayment of the funds to be advanced to the principal. Inquiries should be made by the surety as to the nature and extent of the assets and liabilities of both the principal and the individual indemnitors. As the principal is seeking the extension of loans from the surety in order to enable the principal to perform obligations owed by both the principal and indemnitors, each of the principal and indemnitors should be prepared to collateralize such loans. The surety’s leverage is greatest before it begins extending such loans and, therefore, the availability of equity to secure such loans should be explored immediately and the necessary mortgages and financing statements should be obtained promptly in recordable form.

In the event collateral is obtained from the principal, but not at the same time the loan is given, and the principal thereafter, within 90 days, files a petition for bankruptcy protection, the collateral given to the surety may be deemed to have been a voidable preferential transfer. In that event, the surety faces the risk of losing the protection of the collateral it obtained and having its status revert to that of a general unsecured creditor.

It should be noted that some aggressive trustees may argue that, even where collateral is obtained at the same time as the surety makes its loan, such collateral may still be subject to avoidance as a preferential transfer. The basis for an attack by the trustee against the surety’s collateral would likely be that the surety, by virtue of its bond obligation, was a co-debtor of the principal. Therefore, in advancing funds to be utilized by the principal to discharge an obligation which the surety would otherwise have had under its performance or payment bond, the surety was effectively seeking to improve its position against that of other creditors during the preference period, which is the situation which the Bankruptcy Code’s preference provisions seek to avoid.

The surety's argument in response is that, under its bonds, it had no obligation to provide any financing to its principal. Therefore, its decision to provide such financing represented a contemporaneous exchange of new value for the collateral received, insulating the transaction under Section 547(c)(1) from the trustee's avoidance powers. In addition, the surety's financing of the principal in lieu of direct payment to subcontractors and materialmen included, implicitly, the waiver of the surety's equitable lien to the contract proceeds in the hands of the owner, representing, effectively, the exchange of new value for the collateral received. Finally, the surety's financing of the principal enabled the principal to satisfy what would otherwise constitute construction trust fund claims of subcontractors and materialmen, thereby freeing up the principal's contract receivables from such claims, resulting in the creation of new value.

While the surety's position is correct, there is no assurance that a court will recognize these concepts of new value. Therefore, in considering the surety's options in dealing with a financially troubled principal, care must be taken in assessing the risks of the bankruptcy court voiding the security interests received by the surety in financing the principal in the event of a subsequent bankruptcy. If financing is deemed a prudent risk, explicit recognition in the financing documents of the new value received may serve to augment the surety's prospects of protecting its collateral from attack in a subsequent bankruptcy. Alternatively, if a choice of collateral is available, obtaining collateral from an indemnitor, rather than directly from the principal, may decrease the likelihood of facing a voidable preference battle if the indemnitor is less likely to be at risk of an imminent bankruptcy filing.

The surety also must be mindful of the fact that, while the 90-day preference period applies to most creditors of the debtor, as previously noted, a broader one-year preference period applies to transfers from the principal to or for the benefit of an insider of the principal. While, generally, insiders are those who are the owners or officers of the debtor or their family members, insider rules are also extended to those who are deemed to have exercised control over the debtor prior to the filing of its petition in bankruptcy. Therefore, if the financing arrangements made between the debtor and the surety are such that the surety may be deemed to have assumed effective control over the debtor's operations, the surety may be deemed an insider, and any payments made by the principal to the surety or collateral received by the surety within one year of the bankruptcy filing may be avoided. Therefore, one of the risks faced by the financing surety is the possibility that the terms of the financing agreement are deemed to have enabled the surety effectively to assume such a degree of control over the principal's operations as to expose the surety to insider status. While the surety may dispute such contention, even if insider status is determined, the surety may still escape application of the voidable preference rules under the new value exception as discussed above.

IV. FILING THE AGREEMENT OF INDEMNITY.

It is usually wise to file the indemnity agreement in order to perfect the assignment provisions generally contained in those agreements. Those assignment provisions usually will include assignments of the principal's accounts receivable, whether emanating from bonded contracts or unbonded contracts; rights in machinery, equipment and materials, whether used on bonded contract sites or elsewhere; the principal's rights in subcontracts; and the principal's rights in and to causes of action arising out of the principal's contracts or subcontracts.

While these assignment rights may be enforceable against the principal without the filing of the agreement of indemnity, they will not be enforceable against third parties, including a trustee in bankruptcy, in the absence of the filing of a UCC-1 financing statement.

Generally, the agreement of indemnity executed by a principal includes a statement that the indemnity agreement constitutes both a security agreement and financing statement under the Uniform Commercial Code, enabling the surety to file the indemnity agreement and obtain a perfected security interest in receivables, equipment and choses of action assigned.

The mechanics of filing the indemnity agreement are facilitated by the power of attorney clause commonly found within such indemnity agreement enabling an officer of the surety to execute a UCC-1 financing statement on behalf of the principal and enabling the surety to proceed expeditiously with a filing without any participation by the principal itself.

Although sureties are sometimes lulled into the belief that their subrogation rights afford them adequate protection in connection with claims they might have to receivables on bonded contracts, those rights at times are not as extensive as the rights which might be obtained through the assignment clauses of the general indemnity agreement. For example, where the surety's bonds have been issued to different owners, under most forms of the general indemnity agreement the assignment rights to contract receivables afford the surety the benefit of cross-collateralization so that losses on one project may be offset by recourse to profits obtained on other projects.

Because a surety's rights under the doctrine of equitable subrogation arise only when the surety actually pays a claim, the surety's subrogation rights may not yet have vested at the time a contract receivable is due to be paid to the principal. Accordingly, the surety's assignment rights may provide critical protection to the surety where it has not yet paid any losses under the particular contract for which a receivable is due.

Since the assignment provisions under the agreement of indemnity are usually contingent upon the principal's default under such agreement or under the bonds, care should be given to determine whether the assignment rights have matured. In addition to the assignment provisions in the indemnity agreement, security interests in receivables, equipment, vehicles and other assets of the principal or indemnitors may be obtained as part of the agreement to finance the principal, in which event UCC-1 financing statements must also be filed with respect to such assignments in order to protect the surety's interests in such collateral.

V. FINANCING THE BANKRUPT PRINCIPAL

Contractors who specialize in public works projects are dependent upon their ability to secure bonds in order to obtain work. Once a public works contractor files for bankruptcy protection, if it is going to attempt to reorganize and secure new work, an accommodation with its surety will be essential to its reorganization or it will have virtually no chance to reorganize as a public works contractor.

But even before long term reorganization prospects may be addressed, it must be determined whether the existing bonds are property of the debtor's estate and whether they continue to secure laborers, subcontractors and materialmen performing work on existing jobs. If they do not, the laborers, subcontractors, and materialmen are unlikely to be willing to continue to render services and supply materials in furtherance of the public works project, and the debtor's operations will be paralyzed, assuming that it does not have other sources of financing from which COD payments can be made. Therefore, upon filing its petition in bankruptcy, the bankrupt principal may attempt to argue that bonds issued by its surety are property of the estate within the meaning of Section 541 of the Bankruptcy Code.

A. A SURETY BOND IS NOT PROPERTY OF THE DEBTOR'S ESTATE

In order for the surety to properly protect its interests and to maximize its leverage in dealing with the debtor-in-possession or its trustee, it must firmly establish that its bonds are not property of the estate. This threshold battle is often critical to properly establishing the surety's rights in the pending bonded contracts.

A debtor's insurance coverage is property of the debtor's estate. Therefore, it is important for surety counsel to educate the Court and other parties in interest that a surety bond is not a type of insurance, but, rather, is a type of credit instrument. As noted by the court in A.J. Kellos Constr. Co. v. Balboa Ins. Co., 495 F. Supp. 408, 412 (S.D. Ga. 1980), a surety bond is a tripartite contractual relationship wherein a third party, the surety, is answerable to an obligee for the debt, default, miscarriage, or non-performance of another, the principal (citing RESTATEMENT OF SECURITY § 82 (1941)); see also L & A Contracting Co. v. Southern Concrete Servs., 17 F.3d 106, 109 n.6 (5th Cir. 1994) (citing RESTATEMENT (THIRD) OF SURETYSHIP (sic) § 1 (Tentative Draft No. 1, 1992)). Conversely, the court noted that an insurance relationship, by definition, is bipartite with the insurer owing a duty directly to the insured. A.J. Kellos Constr. Co., 495 F. Supp. at 412-413.

Under a surety contract, simply paying a surety bond premium does not end the involvement of a principal. Instead, a principal always remains liable to repay any losses which the surety sustains. RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY §§ 1, 18 cmt. a (1995). Under a common liability insurance policy, however, payment in full of a premium ends the involvement and obligation of the insured.

Additionally, a surety does not intend to assume any risk on behalf of its principal in bonding its principal's obligations. The surety instead evaluates the circumstances of the principal's performance and will only enter into a surety arrangement if it finds that a principal's

assets are sufficient to cover any potential losses. See Daniel Mungall, Jr., Liability of Bonding Companies, THE LAW OF DISTRESSED REAL ESTATE: FORECLOSURE, WORKOUTS, PROCEDURES, § 27A.02 (Clarke, Boardman & Callaghan 1st ed. 1992). An insurer, on the other hand, assumes risks for its insured in exchange for a premium payment. Based on these fundamental distinctions, it has been frequently held that a surety bond is not an insurance policy. See generally, 72 C.J.S., PRINCIPAL AND SURETY § 6(a); Buck Run Baptist Church, Inc. v. Cumberland Surety Ins. Co., 983 S.W.2d 501 (Ky. 1998); Cates Constr. Co. v. Talbot Partners, 980 P.2d 407 (Cal. 1999).

Federal courts addressing the issue have specifically held that a surety bond is not part of a bankrupt debtor's estate. See, e.g., Matter of Lockard, 884 F.2d 1171, 1177 (9th Cir. 1989) (“[T]he ‘overwhelming weight of authority’, under both the Bankruptcy Act and Code holds that a contractor [principal] has no property interest in a surety bond issued by a third-party [surety] to guarantee the contractor’s performance on its commercial or personal services contracts.”); In re Mansfield Tire and Rubber Co., 660 F.2d 1108, 1115 (6th Cir. 1981) (court held that debtor could not claim any legal or equitable interest in surety bonds); In re McLean Trucking Co., 74 B.R. 820, 826 (Bankr. W.D.N.C. 1987) (court found that a surety bond is not property of the debtor’s estate); In re Fintel, 10 B.R. 50, 51 (Bankr. D. Or. 1981) (court held that corporate surety bond was not property of a bankrupt debtor’s estate). See also In re Buna Painting and Drywall Co., Inc., 503 F.2d 618, 619 (9th Cir. 1974); Globe Constr. Co. v. Oklahoma City Housing Auth., 571 F.2d 1140, 1143 (10th Cir. 1978), cert. denied, 439 U.S. 835 (1978); Matter of Stanndco Developers, Inc., 534 F.2d 1050, 1052-53 (2d Cir. 1976).

B. SURETY BONDS AS A “FINANCIAL ACCOMMODATION”

Having determined that surety bonds do not constitute property of the debtor’s estate, one must look to the Bankruptcy Code to define the nature of the surety’s relationship with its principal. This is important in order to establish the rights which a surety may assert in its principal’s bankruptcy.

Courts addressing the status of sureties have found that surety bonds are contracts of financial accommodation under Bankruptcy Code §§ 365(c)(2) and (e)(2)(B). In re Computer Communications, Inc., 824 F.2d 725, 730 (9th Cir. 1987) (adopting In re Wegner Farms Co., 49 B.R. 440 (Bankr. N.D. Iowa 1985)). See also Matter of Edwards Mobile Homes Sales, Inc., 119 B.R. 857, 859 (Bankr. M.D. Fla. 1990); In re Taggatz, 106 B.R. 983 (Bankr. W.D. Wis. 1989).

While executory contracts are generally subject to being assumed by a debtor or its trustee subject to the conditions set forth in Section 365 of the Bankruptcy Code, financial accommodations may not be assumed by the trustee without the consent of the party providing the financial accommodation, i.e., the surety, under Section 365(c)(2).

C. SURETY CONTROL OVER ASSUMPTION OR REJECTION OF EXECUTORY BONDED CONTRACTS

Section 365(b)(1) of the Bankruptcy Code states:

If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee –

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurances of future performance under such contract or lease.

In the context of most bankruptcies, most principals will be in default of some or many of their bonded contracts and will be unable to assume them following these standards.

For the trustee or debtor to comply with Section 365(b)(1)(A), the losses incurred as a result of the debtor's default must either be paid upon assumption of the contract or promptly thereafter. The likelihood of the debtor having the resources to promptly cure is usually small, in the absence of a cooperative financing surety.

To comply with Section 365(b)(1)(B), the debtor or trustee must also pay outstanding claims of materialmen and subcontractors. Undoubtedly, the contract will contain a provision requiring payment to subcontractors or materialmen. Therefore, payment of all sums due and owing to subcontractors and material suppliers will have to be made by the trustee or debtor if it is to accept the executory contract in the face of objection by the surety. Again, this is an obstacle which most debtors will be unable to meet.

Finally, under Section 365(b)(1)(C) of the Code, in order to assume a construction contract, the trustee must provide adequate assurances to the obligee that it can perform such contract. The most common way of providing these adequate assurances is to have a surety guaranty performance. Because the trustee cannot assume the bonds posted by the surety, it would have to obtain bonds from a new surety. The prospect of obtaining such new bonding is generally slim or none.

The result is that a surety opposing the debtor's efforts to assume an executory contract will generally be well positioned to have the debtor either admit its inability to assume or to have the court order rejection and abandonment and the lifting of the automatic stay so as to

allow prompt completion by the surety or the obligee to avoid irreparable harm to their interests.

D. THE CONSTRUCTION TRUST FUND AND THE FINANCING ORDER

As noted above, the surety generally has insurmountable leverage over whether the principal may continue to perform its bonded contracts after a bankruptcy filing. In those limited circumstances where the surety concludes that it desires to allow its principal to perform the bonded work and allow its bonds to continue to serve as a credit accommodation to the debtor, it should exert its leverage fully to obtain a financing order pursuant to Section 364 of the Bankruptcy Code securing its interests in project proceeds and providing the surety with priority status with respect to its claims. Such order should be structured on the basis that the surety, by allowing the debtor to utilize contract proceeds which are subject to the surety's priority subrogation rights and by providing the debtor with a credit accommodation in the form of its bonds, is entitled to special protections for the use of such funds.¹

In negotiating the terms of a prospective financing order with the debtor, the surety should seek to obtain the advantages afforded by Section 364(c) of the Bankruptcy Code to a party providing any financing or extension of credit. Under Section 364(c), a financing surety may seek three types of protection through a financing order: (1) super-priority status over all other administrative claims; (2) liens on the debtor's unencumbered property; and (3) junior liens on the debtor's encumbered property.

To obtain super-priority administrative expense status under Section 364(c)(1) of the Bankruptcy Code for its surety, the debtor will be required to show that credit is unavailable on more favorable terms. This is not an insurmountable obstacle, as most construction contractors who have been forced to seek protection under the Bankruptcy Code are in no condition to obtain financing from any sources other than its surety; and the surety is under no obligation to finance. Fischer Constr. Co. v. Fireman's Fund Ins. Co., 420 F.2d 271 (10th Cir. 1969). The debtor will have to show that the terms of the transaction are "fair, reasonable and adequate, given the circumstances of the debtor-borrower and the proposed lender." In re The Crousa Group, Inc., 71 B.R. 544, 549 (Bankr. E.D. Pa. 1987).

It should be noted that there is a reported decision in which a debtor unsuccessfully sought super-priority status for its surety under Section 364(c)(1). Id. There, however, the court concluded that the financing being extended by the surety was only temporary and that a decision had already been made by the surety to replace the debtor on the bonded jobs. Id. Thus, the court was not convinced that the standards enunciated under Section 364(c)(1) had been met. Id. In most circumstances where a surety is willing to finance its principal in

¹ The surety's subrogation rights to the bonded contract proceeds are beyond the scope of this paper, but a thorough understanding of such rights is indispensable to securing a properly encompassing financing order. See generally George J. Bachrach and John V. Burch, The Surety's Subrogation Rights, THE LAW OF SURETYSHIP, 419 2d ed., (Edward G. Gallagher ed., 2000); J. Michael Franks and Michael E. Evans, A Defense of Established Landmarks: Claims of Construction Sureties to Contract Funds Under Chapter 11, 25 Tort & Ins. L.J. 28 (1989); T. Scott Leo, The Financing Surety and the Chapter 11 Principal, 26 Tort & Ins. L.J. 45 (1990).

bankruptcy, however, the debtor should be able to meet the requirements of Section 364(c)(1) and obtain for the surety the benefits of super-priority administrative expense claim status.

Both the surety's extension of its bond to cover the debtor's performance and payment obligations and the surety's agreement to permit the debtor to utilize contract proceeds and retainage subject to the surety's prior subrogation claims constitute extensions of credit which would justify allowing the surety a super-priority administrative expense claim, under Section 364(c) to the extent of the surety credit provided, where such credit results in substantial benefit to the estate. Because the surety effectively exercises life or death power over the debtor in its reorganization, it may be able to obtain an agreement from the debtor to allow the surety to receive this super-priority administrative claim. The surety may face challenges from third party unsecured creditors who will assert that the extension of credit by the surety will not result in substantial benefit to the estate but, rather, will ultimately benefit only the surety in reducing the losses it will sustain under its existing bonds. On the other hand, the debtor and the surety may argue and present compelling evidence that the only way the debtor is likely to be able to meet its obligations and/or to ever pay any lenders whose security consists of pre-petition assignments of receivables is for the principal to complete its work on hand. If it cannot obtain the surety credit needed to operate, the debtor's receivables likely will evaporate, as such receivables will be recouped by the various project owners as a credit against the damages flowing from the debtor's default or will be otherwise unavailable to the debtor and its creditors because such funds will be subject to the surety's subrogation rights. Where the surety is able to convince the court that there will be a substantial benefit to the estate as a result of its financing, priority may be obtained which will enable the surety to receive payment ahead of virtually all other administrative expense claims, including claims for counsel fees by the debtor's own counsel and the fees of any bankruptcy trustee. Such super-priority administrative expense status thus provides tremendous leverage for the surety and incentive to the debtor's counsel and trustee to cooperate with it; because unless the surety succeeds in avoiding loss resulting from its extension of surety credit, in the absence of an agreed carve out to protect their fees, neither debtor's counsel nor the trustee will be paid without the surety's consent.

While only the trustee or debtor may apply for super-priority administrative expense claim status on behalf of a creditor, such application should be one of the bargained-for prerequisites to the surety's extension of credit.

Where super-priority status cannot be achieved due to objections by the debtor, other creditors or the court, if the surety nonetheless wishes to proceed with financing, it should be entitled under Section 364(b) to have its claims treated as ordinary expenses of administration under Section 507(a)(1). This at least provides the surety with priority status over the claims of pre-petition general unsecured creditors and taxing authorities.

The financing order may extend the surety's rights far beyond its traditional subrogation rights to contract funds. The order may specifically recognize the surety's continuing rights under its indemnity agreement and secure such rights on a priority basis not only in all receivables, but, also, in all unencumbered assets which the debtor may have, including any unencumbered vehicles, machinery, equipment, etc. pursuant to Section 364(c)(2).

Attached hereto is a sample of a proposed financing order pursuant to which a surety may convince its bankrupt principal to allow the turnover of all past and future progress payments to the surety acting as escrow agent. A detailed recitation of its terms need not be rehashed, as most are self-explanatory. The following are its most salient provisions. All past and future progress payments and retainage are deposited into project-specific escrow accounts dedicated to the performance of the bonded contract work and payment of subcontractors and material suppliers. The order provides that all progress payments should be paid to the surety free and clear of municipal mechanics lien claims because the owners' interest in securing performance of the contract work upon the debtor's default justifies the owners' dedication of the contract funds first to future performance of the contract work. Because payments into escrow did not constitute payments to the contractor, there are no funds being paid to which the municipal mechanics lien claims could attach², and, therefore, contract balances are not depleted through municipal mechanics lien claims.

The surety is granted valid, perfected, and enforceable first liens and security interests on all proceeds of the various construction contracts in exchange for its financing of the debtor in the form of lending to the debtor the project proceeds to which the surety would otherwise have had subrogation rights.

The surety is also empowered to extend post-petition loans or advances to the debtor in its sole discretion and is given security interests in the debtor's post-petition receivables. The surety is also granted the right to seek a super-priority administrative expense claim and is granted a cross-collateralized perfected assignment on both pre- and post-petition receivables of the debtor. In the event of a post-petition default for failure of the debtor to pay the surety its obligations as set forth in the order, the bonds can be deemed, in the sole discretion of the surety, inapplicable to the debtor-in-possession.

The surety is also provided a super-priority lien on all property of the debtor except to the extent of valid and duly perfected pre-existing liens on inventory, machinery, and equipment.³ The order provides that the surety's super-priority status will continue despite any conversion of the proceedings from Chapter 11 to Chapter 7 or the appointment of a trustee.

Third parties are given only 30 days within which to file an objection to the priority of the surety's liens, security interest and subrogation rights following which any right to attack the surety's liens, security interest and subrogation rights would be deemed waived and forever forfeited.

In summary, the surety, in consideration for its consent to allow its surety bonds to continue to secure the debtor's post-petition performance and payment obligations, is given

² See *In re Modular Structures*, 27 F.3d 72 (3d Cir. 1994); *In re Pacific Marine Dredging*, 79 B.R. at 929 (due to debtor's breach of contract in failing to pay subcontractors and suppliers, debtor has no legal or equitable interest in the contract balances and such balances are not property of the estate).

³ There are circumstances under which a financing surety may be able to prime even the position of a pre-petition secured creditor. Section 364(d) allows such financing where more favorable terms are unavailable and where the existing lienholders who will be primed will be adequately protected.

effective control over all unencumbered assets of the debtor and super-priority administrative claim status to secure any loans, losses or expenses which the surety might extend or incur.

It should be noted that the Bankruptcy Code protects a surety extending credit based upon a financing order from the possibility that the protections afforded by the order will be lost in a subsequent appeal challenging its terms. Specifically, Section 364(e) of the Code provides as follows:

The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

This section recognizes the exigencies faced by a debtor which has no ability to continue to operate without securing financing on an expedited basis. Without some ability to rely upon the priority and secured status provided in the financing order, secured lending to debtors effectively would be destroyed.

In order for the surety to avail itself of the full protection afforded by Section 364(e) against the financing order being vacated on appeal, the surety should present affirmative evidence of its good faith in support of the debtor's application for such order. In addition, the surety should require the debtor to certify in its moving papers its belief as to the surety's good faith. As noted, the financing order should contain an explicit finding of the surety's good faith.

The surety should also verify that proper notice to approve the financing was given by the debtor to the U.S. Trustee, to any secured creditors, and all creditors asserting liens on the property subject to the financing order and to the creditors' committee, if constituted, or else to the twenty largest unsecured creditors. Failure to provide adequate notice may invalidate the protections otherwise secured in favor of the surety.

While the extension of surety bond credit and the financing of a debtor-principal by a surety may be appropriate in only limited circumstances, the protections available in the Bankruptcy Code to a surety willing to offer surety credit and/or financing can provide substantial leverage which can be utilized by the surety to reduce its loss exposure under its bonds.

CONCLUSION

While the financing of a troubled principal is often a risky proposition and is not usually a wise first option for the surety, in appropriate circumstances carefully crafted financing agreements can provide a framework for a principal in economic distress to fulfill its bonded obligations, thereby avoiding the project disruptions, inefficiencies and remobilization costs which arise when a defaulting contractor must be replaced in the midst of an ongoing project. In sum, given the proper situation, substantial savings can be realized through controlled financing of the troubled principal.

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

-----X
In Re:

UNLUCKY CONSTRUCTION CO., INC.,

Debtor.

Case No.
In Proceedings for a
Reorganization Under Chapter 11
Hon.
Bankruptcy Judge

-----X
**ORDER AUTHORIZING THE TURN OVER OF CONSTRUCTION TRUST FUNDS,
THE EXTENSION OF POST PETITION SECURED CREDIT, THE GRANTING OF A
SUPER-PRIORITY LIEN, AND FOR OTHER RELATED RELIEF**

This matter having been brought before the Court by Mason & Associates, P.L.L.C., (Perry Mason, Esq., appearing), attorneys for Unlucky Construction Co., Inc. (hereinafter “Unlucky” or the “Debtor”), the Debtor and Debtor-in-Possession herein, upon the Debtor’s application for authorization to, inter alia, (i) use certain construction trust funds and trust property of Behemoth Surety Company (hereinafter "Surety"); (ii) borrow funds and obtain other financial accommodations from Surety; (iii) continue, as a financial accommodation to the Debtor, certain pre-petition bonding on certain terms and conditions; (iv) grant Surety security interests and liens on Debtor’s property to secure post-petition advances and other financial accommodations and to cross-collateralize all obligations of Debtor to Surety; and (v) to the extent necessary, grant Surety a super-priority administrative expense claim as of the date of Debtor’s petition (the “Application”), upon due and adequate notice to Wolff & Samson, P.A., attorneys for Surety, the United States Trustee, the twenty (20) largest unsecured creditors of the Debtor, and those parties having filed an appearance and requested notice pursuant to Rule 9010 of the Federal Rules of Bankruptcy Procedures (the “Bankruptcy Rules”) and in the presence of Wolff & Samson, P.A. (Armen Shahinian, Esq., appearing), attorneys for Surety; and it

APPEARS that Surety had issued pre-petition to Unlucky, as principal, performance and payment bonds bearing the bond numbers and for the obligees and projects listed on the annexed Exhibit A (said bond numbers, obligees and projects are collectively referred to herein as the “Bonds,” the “Project Owners” and “Projects,” respectively); and it

FURTHER APPEARS that the Court has determined that progress payments that are outstanding, together with progress payments and retainage which may be earned and due in the future with respect to the Projects (collectively, “Project Proceeds”), when paid by Project Owners constitute trust funds for the benefit of laborers, subcontractors, suppliers and materialmen of the Projects, pursuant to the terms of the General Indemnity Agreement (hereinafter “General Indemnity Agreement”) executed by the Debtor in favor of Surety, a copy of which is attached hereto as Exhibit B, and pursuant to Article 3-A of the New York Lien Law, subject to the rights and interests of Surety under (i) the trust provisions of the General Indemnity Agreement; (ii) where applicable, Article 3-A of the New York Lien Law (Lien Law Section 70(10)); and (iii) common law principles of subrogation to the extent Surety has made or may make payments under the Bonds; and it

FURTHER APPEARS that the Court has determined that Unlucky, as a Debtor-in-Possession, is (i) not a party to the Bonds; (ii) incapable of assuming or assigning the Bonds under 11 U.S.C. Section 365(c)(1)(B)(2); (iii) incapable of obtaining bonding from any source except Surety to complete the Projects; and (iv) unlikely to continue its business or reorganize under Chapter 11 unless Surety agrees to (a) accept and deem Unlucky, as a Debtor-in-Possession, to be a party to the Bonds; (b) allow Debtor-in-Possession to use trust property, *i.e.*, the Project Proceeds as provided hereunder; and (c) make post-petition loans or advances

available to the Debtor as approved by Surety in its sole discretion to complete the Projects;
and it

FURTHER APPEARS that the Court has determined that Surety is unwilling to bond Unlucky, as a Debtor-in-Possession, to extend post-petition financing by permitting the use of Project Proceeds, and to make any loans to Debtor in Surety's discretion, unless the Court grants to Surety a lien on the Project Proceeds to cross-collateralize and secure payment of the Debtor's Post-Petition and Pre-Petition Obligations to Surety (as hereinafter defined) and to secure payment of the Debtor's obligations to laborers, subcontractors, suppliers and materialmen on the Projects having proper claims under its Bonds and Debtor's obligations to Surety to the extent Surety has paid or does hereafter pay any claims or incurs any losses under the Bonds or for which Debtor is liable under the General Indemnity Agreement;

NOW, THEREFORE, the Court, based upon the Application and the record of the proceedings before the Court, including the objections filed on behalf of _____, and upon due deliberation, finds:

(a) Debtor is unable to obtain unsecured credit pursuant to 11 U.S.C. Section 364(b) allowable as an administrative claim under section 503(b)(1) of Title 11;

(b) Debtor is unable to obtain credit or to incur debt otherwise than as hereinafter ordered;

(c) Adequate notice of the Application and the hearing with respect thereto has been given pursuant to Bankruptcy Rules 2002 and 4001(c), and 11 U.S.C. Section 102(1), as required by 11 U.S.C. Section 364(c), and that no additional notice of or hearing on the relief sought is required;

(d) The financing arrangements pursuant to which loans, advances and other financial accommodations will be made and extended to Debtor by Surety are entered into by Surety in good faith as provided by 11 U.S.C. Section 364(e); and

(e) Good and sufficient cause has been shown to justify the granting of the relief herein;

IT IS on this _____ day of _____, _____,

ORDERED as follows:

1. Project Owners shall immediately turn over Project Proceeds to Surety at _____; for purposes hereof, earned progress payments shall be deemed to refer to payments due for work properly performed under the Debtor's contracts with Project Owners and such payments shall not be withheld due to the Debtor's failure to pay laborers, subcontractors, suppliers and materialmen, due to the assertion of municipal mechanics' liens filed in accordance with the provisions of Article 3-A of the New York Lien Law, due to the failure of the Debtor to maintain an adequate work force at the Project site or due to the failure of the Debtor to adhere to the Project schedule; and

2. The Project Owners shall have no liability to laborers, subcontractors, suppliers and materialmen pursuant to the provisions of Article 3-A of the New York Lien Law by virtue of their making the Project Proceeds payments directed herein to Surety, despite the filing of mechanics' liens by any such laborers, subcontractors, suppliers or materialmen; and

3. Surety shall hold all Project Proceeds received in accordance with Paragraph 1 above in separate escrow accounts which shall be established for each Project. Pending further order of the Court, funds from each escrow account shall be used only to fund

the completion of the respective Project, including but not limited to payment of laborers, subcontractors and materialmen for labor, services and materials, and payment of the Debtor's reasonable post-petition general and administrative expenses, including but not limited to the salaries of the Debtor's office personnel, all lease expenses for realty, machinery, equipment and vehicles, all insurance, payroll taxes, employee benefit payments, telephone, office expenses, maintenance, fuel and oil, utilities, postage, licenses and registration (hereinafter "General and Administrative Expenses") which have been incurred since the filing of the petition herein or will be incurred in the future, subject to Surety's approval of such costs and expenses. Counsel for the Creditors' Committee and any other party in interest shall be provided with a list of expenditures to be made from such escrow accounts upon request and unless a party in interest objects by written notice to Debtor's counsel and Surety's counsel within three (3) business days of service of the list, Surety shall be authorized to pay said expenditures. Expenditures timely objected to shall not be paid until further order; and

4. The Debtor is hereby authorized, consistent with Article 3-A of the New York Lien Law (Lien Law Section 70), to pay from each escrow account, subject to Surety's approval, pre-petition claims of laborers, subcontractors, suppliers and materialmen of the Projects; and

5. In consideration for the use of the Project Proceeds which are subject to the trust obligations created in favor of Surety to complete the Projects and as an express condition of Surety's agreeing to deem Unlucky, as Debtor-in-Possession, a party to the Bonds, the Debtor is authorized, and by this order does hereby grant, convey and assign to Surety valid, perfected and enforceable first liens and security interests in any and all pre- and post-petition Project Proceeds, including but not limited to progress payments and retainage, in

which the Debtor has or will acquire any interest, which security interests shall be deemed to be valid, enforceable and perfected without any further action by Surety (which is not necessarily “adequate protection” as that term is defined in 11 U.S.C. Section 361); and

6. Debtor is authorized and empowered to borrow monies and/or obtain other financial accommodations from Surety, provided that Surety shall have the right but not the obligation to fund post-petition loans or advances requested by the Debtor, at such times and in such amounts as Surety shall determine in Surety’s sole discretion (the “Post-Petition Advances”), provided further that the Debtor shall submit to Surety and any party in interest upon request weekly (i) a written list of estimated expenditures with such back-up documentation as Surety may require; and (ii) an accounting of the receipts and expenditures of Surety’s Post-Petition Advances; and

7. Surety is hereby granted as security for any and all Post-Petition Advances it may make in accordance with Paragraph 6 above (which is not necessarily “adequate protection” as that term is defined in 11 U.S.C. Section 361), valid, perfected and enforceable first liens and security interests in any and all pre- and post-petition Project Proceeds, including but not limited to progress payments and retainage, in which the Debtor has or will acquire any interest, which security interests shall be deemed to be valid, enforceable and perfected without any further action by Surety; and

8. To the extent it is determined that the collateral pledged and the protection afforded Surety for the Debtor’s use and consumption of Project Proceeds (trust property) and any Post-Petition Advances made to the Debtor by Surety proves to be inadequate, Surety shall be entitled to, as of the petition filing date, a super-priority administrative expense claim, pursuant to 11 U.S. C. Section 507(b), granting Surety a priority

over any and all administrative expenses of the kind specified in or ordered pursuant to Sections 101, 326, 330, 331, 503(b), 506(c), 507(a), 507(b) or 726(b), whether in this proceeding or in any superseding proceeding, which shall serve as additional protection to Surety; and

9. In consideration for and as an express condition of Surety's agreeing to (i) Debtor's continued ability to use Project Proceeds as provided hereunder, (ii) any Post-Petition Advances made by Surety, and (iii) Surety's deeming Unlucky, as Debtor-in-Possession, a party to the Bonds, the Debtor is authorized and by this order, does hereby grant, convey and assign to Surety a continuing first lien and security interest in and to (a) any and all Project Proceeds including but not limited to the due, earned and outstanding progress payments and retainage (pre- or post-petition) and earned progress payment and retainage due in the future from the Projects, which security interests shall collateralize Unlucky's obligations to Surety under the General Indemnity Agreement attached hereto as Exhibit B, which General Indemnity Agreement is accepted, ratified, and confirmed and which shall continue in full force and effect. The security interest so granted is not necessarily "adequate protection" as that term is defined in 11 U.S.C. Section 361.

10. Any and all obligations of the Debtor to Surety shall be due and payable on ten (10) days' written notice to Debtor and its counsel in the event of a material breach or default of the terms of this order, which default may be called in the sole discretion of Surety and, thereafter, the Bonds automatically shall be deemed inapplicable to Unlucky, as Debtor-in-Possession, and Surety may seek enforcement of this order upon two (2) days' written notice to Debtor and its counsel, except that the failure by Surety to so enforce the order shall not be deemed to be a waiver by Surety of any of its rights hereunder; and

11. The security interests and liens of Surety granted pursuant to this order shall be superior to all other security interests and liens on all of the property of the Debtor, except valid and duly perfected pre-existing liens on the inventory, tax refunds, instruments, goods, equipment, furniture, vehicles, machinery, fixtures, leases, insurance policies and accounts arising in connection with construction projects on which Surety issued no bonds, and the proceeds thereof as of the Debtor's Chapter 11 filing; and

12. The security interests and liens herein granted Surety (i) are and shall be valid, perfected, enforceable and effective as of the date of this order without any further action by the Debtor or Surety and without the execution, filing or recordation (under non-bankruptcy law) of any financing statements, security agreements or other documents with such perfection being binding upon any subsequently appointed trustee, either under Chapter 7 or 11, and upon any creditors who have or may hereafter extend secured or unsecured credit to the Debtor or Trustee; and (ii) shall remain superior in right to any other lien or security interest hereafter created or arising; and

13. The provisions of this order shall be binding upon Surety, the Debtor, any creditors of the Debtor, any other party in interest and their respective successors and assigns, including without limitation any subsequently appointed trustee either in a Chapter 7 or 11 proceeding, and the provisions of this order and the validity of any actions taken pursuant hereto shall survive entry of an order which may be entered confirming any plan of reorganization respecting the Debtor, appointing a trustee or examiner for the Debtor, converting this case from one under Chapter 11 to one under Chapter 7 of Title 11, United States Code (the "Bankruptcy Code"), or the dismissal of this case and the terms and the provisions of this order, as well as the priorities, liens and security interests created hereunder,

shall continue in this or any superseding case under the Bankruptcy Code, and such liens and security interests shall maintain their priority as provided by this order until satisfied and discharged; and

14. The Debtor be and hereby is authorized and directed to deliver and execute such financing statements, assignments, security agreements, mortgages and other documents as Surety may require and Surety is authorized to receive, file or record the same as it may, in its sole discretion, deem appropriate; and

15. Surety shall be entitled to the full protection of 11 U.S.C. Section 364(e) with respect to debts, obligations, liens and security interests created, authorized or incurred pursuant to this order; and

16. Parties that claim to be prejudiced by the entry of this order are permitted to file motions for relief herefrom no later than thirty (30) days from the date hereof or within thirty (30) days of the date of entry of an order authorizing a creditors' committee to employ counsel; whichever is later; and

17. The Debtor acknowledges the validity of Surety's interests in and to the Project Proceeds as surety under the Bonds. The failure of any other party in interest to file an objection with the Court to the validity, and/or priority of Surety's interests in and subrogation rights to the Project Proceeds not later than thirty (30) days from the date of an order authorizing a creditors' committee to employ counsel shall result in a permanent waiver and bar of all objections by any such party; and

18. Nothing in this order shall be construed as a waiver by either pre-petition or post-petition creditors to any claims which they may have against the Debtor or Surety, and all rights of such creditors against the Debtor and Surety are reserved; and

19. Notwithstanding any provisions herein, all obligations of the Debtor to Surety shall become immediately due and payable, Surety's consent to the use, sale or lease of its Cash Collateral by Debtor shall be immediately revoked, and the bonding continued herein for Unlucky, as Debtor-in-Possession, shall immediately be deemed terminated, without further Court order, in the event of the earlier of the entry of an order (i) converting the within proceeding from Chapter 11 to Chapter 7 of the Bankruptcy Code; (ii) authorizing the appointment of a trustee or examiner; (iii) modifying or vacating the Section 362(a) stay of the Bankruptcy Code in favor of any other secured party with respect to collateral subject to the interests of Surety and which order impairs the rights of Surety; or (iv) confirming a plan of reorganization without the express written consent of Surety; and

20. This is a preliminary order pursuant to Rule 4001 and shall become a final order on _____ unless timely objections, if any, are filed and served so as to be received by (i) Mason & Associates, PLLC (Attention: Perry Mason, Esq.) and Wolff & Samson, P.A. (Attention: Armen Shahinian, Esq.) no later than _____. In the event there are timely filed objections, a hearing shall be held on _____ at ___ o'clock, at the United States Bankruptcy Court, _____; and

21. All parties in interest shall be served with a copy of this order by first-class, postage prepaid mail, on or before _____.

UNITED STATES BANKRUPTCY JUDGE

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

-----X
In Re:

UNLUCKY CONSTRUCTION CO., INC.,

Debtor.

Case No.
In Proceedings for a
Reorganization Under Chapter 11
Hon.
Bankruptcy Judge

-----X
FINAL ORDER AUTHORIZING THE TURNOVER OF CONSTRUCTION TRUST FUNDS, THE USE OF TRUST PROPERTY, THE EXTENSION OF POST-PETITION SECURED CREDIT, THE GRANTING OF A SUPER-PRIORITY LIEN, AND FOR OTHER RELIEF

Upon the Application dated _____ of Unlucky Construction Co., Inc. (“Unlucky”), debtor and debtor-in-possession herein (hereinafter “Debtor”) requesting an Order to (i) authorize the use of trust property, (ii) continue, as a financial accommodation to the Debtor, certain pre-petition bonding for Unlucky post-petition as a Debtor-in-Possession on certain terms and conditions, (iii) borrow funds and obtain other financial accommodations from Behemoth Surety Company (hereinafter “Surety”), (iv) grant Surety security interests and liens on the Debtor’s property to secure the diminution in value from the use of Surety’s property and other financial accommodations and as security for all obligations of the Debtor to Surety, and (v) to the extent necessary, grant Surety a super-priority administrative expense claim as of the date of Debtor’s petition, and Unlucky having appeared by its attorneys MASON & ASSOCIATES, PLLC, by Perry Mason, Esq., in support of said application; and Surety and the Official Committee of Unsecured Creditors having appeared in support of said application; and this matter having come before the Court on _____; the parties being represented by their respective attorneys; and the Court having considered the application and having heard the arguments of counsel with respect to the requested relief; and due deliberation had therefor, it is hereby

ORDERED, that the Order Authorizing the Turnover of Construction Trust Funds, the Extension of Post-Petition Secured Credit, the Granting of a Super-Priority Lien, and for Other Related Relief, is approved as a Final Order.

Dated:

UNITED STATES BANKRUPTCY JUDGE