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**THE PRINCIPAL'S BANKRUPTCY - PRACTICAL PROBLEMS
AND POTENTIAL SOLUTIONS IN HANDLING PAYMENT
BOND CLAIMS**

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I. Introduction

When the surety's principal files a bankruptcy case under the United States Bankruptcy Code (the "Bankruptcy Code"),¹ numerous horns and buzzers are set off in the surety's claim office. Whether the principal files under a chapter 11 reorganization or a chapter 7 liquidation, the surety's initial response concerns the status and collection of the contract funds from the principal's contracts bonded by the surety and the control of the performance of those bonded contracts. While the initial combatants on these issues will be the principal, now known as the debtor, and the surety, additional parties to the battle may soon include secured lenders and a committee of unsecured creditors for the principal/debtor.

Much has been written in the surety industry concerning the initial days of the principal's bankruptcy case. Attached to this paper is a **Selected Bibliography - Bankruptcy** detailing many of the books and articles that treat various issues arising during the initial and later stages of the principal's bankruptcy case. Those books and articles discuss the rights and strategy of the surety (the "Surety"), the principal (the "Debtor"), the secured lenders (collectively referred to as the "Bank"), and the general unsecured creditors of the Debtor's bankruptcy case generally represented by the committee of unsecured creditors of the Debtor (the "Committee"). In the event that the Debtor files a chapter 7 bankruptcy case, a trustee (the "Trustee") for the Debtor will be appointed, and the automatic stay will prevent all of the parties from taking any action against the Debtor or the property of the Debtor.² In the event that the Debtor files a chapter 11 bankruptcy case, and continues to operate its business pursuant to sections 1107 and 1108 of the Bankruptcy Code, the automatic stay will be in force and effect. However, the situation is much more fluid in a chapter 11 and each of the parties to the chapter 11 bankruptcy case, including the Surety, the Debtor, the Bank and the Committee, may take actions that seek to at least protect their rights and positions if not improve on their rights and positions.

There is a subset of the Debtor's unsecured creditors that may or may not surface immediately upon the Debtor's filing of its bankruptcy case, but it soon raises major issues for the Surety. That subset is made up of the Debtor's subcontractors and suppliers on the bonded contracts (the "Claimants") who may not have been paid for their labor performed and materials supplied to the Debtor prior to the filing of the bankruptcy case and who may be required or requested to continue to perform work and supply materials on the bonded contracts after the Debtor's filing of the bankruptcy case. While the Claimants may have

¹ 11 U.S.C. §§ 101-1330.

² 11 U.S.C. § 362.

unsecured claims against the Debtor, they may also have valid payment bond claims against the Surety on the various bonded contracts. Furthermore, if it is the intention of the Debtor to continue the performance of the bonded contracts after the Debtor's filing of its bankruptcy case, the Debtor must ensure that any prior defaults in the payment of the Claimants are cured and that the Claimants receive adequate assurance that the Debtor will perform under its subcontracts and purchase orders³ with the Claimants after the filing of the Debtor's bankruptcy case.⁴

Whether or not the Claimants have begun to file their claims against the Surety under the payment bonds, the battle for the control and use of the bonded contract funds has already started among the parties claiming an interest in the bonded contract funds. The Debtor wants to use the bonded contract funds to pay for the performance of the work and the payment of the Claimants going forward during the Post-Petition Period, and may have filed a Motion to Authorize the Debtor's Use of the Bonded Contract Funds as Cash Collateral under section 363 of the Bankruptcy Code.⁵ The Surety and the Bank, pursuant to the Bank's perfected security interest in the accounts of the Debtor under the Uniform Commercial Code, may have either filed Motions to Prohibit the Debtor's Use of the Bonded Contract Funds as Cash Collateral⁶ or have responded to the Debtor's Motion to Authorize the Debtor's Use of the Bonded Contract Funds as Cash Collateral, and both have demanded that in the event the Bankruptcy Court authorizes the Debtor's use of the bonded contract funds as cash collateral, that they be afforded adequate protection.⁷

The issue may also arise in the event that the Debtor seeks to obtain financing from some source, either from an existing source (post-petition financing from the Bank or the Surety), or from a new post-petition secured lender.⁸ If the Surety determines that it is in its best interest to finance the continued performance of the work by the Debtor during the Post-Petition Period, the Surety may seek additional rights with respect to the pre-petition and post-petition generated bonded contract funds.⁹

³ 11 U.S.C. § 365(b)(1).

⁴ In bankruptcy terminology, the time prior to the date of the Debtor's filing of its bankruptcy case is known as the "Pre-Petition Period" and the time from the date of the Debtor's filing of its bankruptcy case going forward is known as the "Post-Petition Period."

⁵ 11 U.S.C. § 363(c)(2).

⁶ 11 U.S.C. § 363(e).

⁷ 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 INS. L. J. 1 (1999).

⁸ 11 U.S.C. § 364.

⁹ 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 INS. L. J. 1 (1999); Bachrach, George J., *Financing the Principal*, in BOND DEFAULT MANUAL, 2D ED. (Duncan L. Clore, ed. 1995), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION; Leo, T. Scott, *Bankruptcy Considerations and Bond Defaults*, in BOND DEFAULT MANUAL, 2D ED. (Duncan L. Clore, ed. 1995), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION; Leo, T. Scott, *The Financing Surety and the Chapter 11 Principal*, 26 TORT & INS. L.J. 1 (1990) and unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 26, 1989.

Depending upon the extent of the Surety's rights to the bonded contract funds, the Surety will attempt to have the bonded contract funds earned pre-petition used to pay the pre-petition claims of the Claimants and to have the post-petition generated bonded and earned contract funds pay the post-petition claims of the Claimants.

This paper will address a number of practical and legal issues involving the Claimant's claims against the Debtor and the Surety, including the processing and payment of the pre-petition and post-petition claims of the Claimants, the Debtor's and the Surety's abilities to settle the claims, and certain preference actions that may be brought against the Claimants, and the Surety, for the Claimants' pre-petition receipt of payments from the Principal/Debtor and/or the Surety's benefit from the payments by the Debtor to the Claimants.

II. The Processing and Payment of the Pre-Petition and Post-Petition Claims of the Claimants

The automatic stay of section 362 of the Bankruptcy Code prevents the Claimants from enforcing their rights to payment against the Debtor for their pre-petition bonded contract claims. While the Claimants may have rights under the trust fund statute of a particular jurisdiction¹⁰ or some other legal or equitable rights to payment from the Debtor, the Claimants will most likely look to the Surety for the payment of their pre-petition bonded contract claims. The Surety will attempt to enforce the rights of the Claimants and the Surety's own rights to the bonded contract funds in order to pay not only the Claimant's pre-petition bonded contract claims, but also their post-petition bonded contract claims as the work is performed on the bonded contracts during the Post-Petition Period.

During the hearings on the Debtor's motion for authority to use the bonded contract funds as cash collateral and/or any motion to approve the financing of the Debtor from some source, the disposition of the pre-petition bonded contract funds and the post-petition bonded contract funds should be addressed. The Bankruptcy Court may well authorize the Debtor to pay the Claimants' pre-petition bonded contract claims from the pre-petition bonded contract funds, and to pay the Claimants' post-petition bonded contract claims from the post-petition bonded contract funds. However, some judges are reluctant to allow the payment of any pre-petition claims early on in the Debtor's bankruptcy case. This puts the Surety in a dilemma in that the Surety wants the Claimants paid their pre-petition claims in order to cure any defaults, and wants the Claimants paid their post-petition claims in order to ensure that the Claimants will continue the performance of the work and the supplying of materials to the bonded contracts.

¹⁰ 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 INS. L. J. 1 (1999); McNaughton, Kim, Jetton, Mary Paty Lynn and Franks, J. Michael, *Surety's Rights to Contract Funds Under Trust Fund Provisions in Indemnity Agreements and Trust Fund Statutes* (unpublished paper submitted at the Surety Claims Institute annual meeting on June 24, 1999); Lawrence, Robert L., Wright, Robert M., Bachrach, George J., and Dolan, William M., III, *The Agreement of Indemnity - The Surety's Handling of Contract Bond Problems: Enforcement of the Surety's Rights Against the Principal and the Indemnitors Under the Agreement of Indemnity*, in THE AGREEMENT OF INDEMNITY - PRACTICAL APPLICATIONS BY THE SURETY (George J. Bachrach, ed. 1990), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION and unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 27, 1989.

Early on in the bankruptcy case, the Surety may have to pay the Claimants directly, and may have to do so over a period of time. The payments will be made with the Surety's money. There are two alternatives:

A. The Surety's Direct Payments.

The Surety may make direct payments to the Claimants by way of a surety claim draft or check. If the Debtor's records are accurate, and the Debtor cooperates with the Surety, the process of the Surety's making direct payment to the Claimants can be sped up significantly. The Surety will have to decide whether it wants to go through its normal payment bond claim process of requiring a proof of claim and affidavit, followed by a review by the Debtor, and then the ultimate payment to the Claimants, or whether some other expedited process can be used. If the Surety is liable to the Claimants under the payment bond, an expedited process may assist the Debtor and the Surety in continuing the performance of the Claimant's work on the bonded contracts without delay and/or significant additional cost.

B. The Surety's Special Account.

If the Debtor has a relatively good accounting system and the ability to generate checks, the Surety may set up a special account subject only to the signature of the Surety but using checks that may be generated from the Debtor's own payment and accounting system. As the pre-petition bonded contract claims are processed, and the Debtor agrees to the amount of the payments, the checks from the Surety's special account may be generated by the Debtor and sent to the Surety for signature. The Surety will then sign the checks, deposit sufficient funds in the Surety's special account to cover the checks, and mail the checks either directly to the Claimants or back to the Debtor to distribute to the Claimants. In a particularly large case with many bonded contracts, many checks may be sent out. Having the Debtor generate the check rather than the Surety generate a check or claim draft may be more expeditious and cut down on the Surety's paperwork. The control over the payment will still be in the hands of the Surety as it will review the Debtor's payment request and the submittal of the checks on the Surety's special account, along with the backup information.

C. The Debtor/Surety Joint Account.

Ultimately, whether through an agreement for the Debtor's use of the bonded contract funds as cash collateral or under some financing agreement with the Debtor, the best form of adequate protection for a Surety is to have the pre-petition bonded contract funds and the post-petition bonded contract funds deposited to a joint account subject to the signatures of the Debtor and the Surety.¹¹ The issues of whether pre-petition bonded contract funds may be used to pay pre-petition bonded contract claims and whether post-petition bonded contract funds may be used to pay post-petition bonded contract claims will be decided in the cash collateral and/or financing stages of the bankruptcy case. Whether the Surety can combine the two sets of bonded contract funds (the pre-petition bonded contract funds and the post-petition bonded contract funds) and the two sets of bonded contract claims (the pre-petition bonded contract claims and the post-petition bonded contract claims) depends on the rights

¹¹ 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 INS. L. J. 1 (1999).

the Surety had prior to the Debtor's petition date and subsequent to the Debtor's petition date subject to what happens during the cash collateral and/or the financing stages of the case. Ultimately, the Surety would like to be able to "cross-collateralize" the pre-petition bonded contract funds and the post-petition bonded contract funds in order to use all of the bonded contract funds, whenever generated or collected, to pay the pre-petition and post-petition claims of the Claimants. Under the appropriate factual and legal circumstances, such an understanding can be reached.

Attached to this paper as **Exhibit 1** is a sample agreement entitled "The Definition and Use of the Pre-Petition Bonded Contract Funds and the Post-Petition Bonded Contract Funds for the Payment of the Pre-Petition Bonded Contract Claims and the Post-Petition Bonded Contract Claims." Exhibit 1 is an attempt to define the timing of the generation and collection of the pre-petition bonded contract funds and the post-petition bonded contract funds, and relate the timing of the generation and collection of those bonded contract funds to the payment of the pre-petition bonded contract claims and the post-petition bonded contract claims. Through the use of the available rights of the Surety as set forth in Exhibit 1, the Surety may be able to treat all of the bonded contract funds coming from the bonded contracts as funds available to pay all of the Claimants' claims on the bonded contracts regardless of whether the bonded contract funds or the bonded contract claims are generated pre-petition or post-petition.

III. The Settlement of Claims - The Claimants' Claims Against the Debtor and the Surety and the Debtor's Affirmative Claims Against the Claimants and Their Sureties.

The processing and payment of the pre-petition bonded contract claims and the post-petition bonded contract claims becomes more difficult if there are disputes between the Claimant and the Debtor and/or the Surety. Outside of the bankruptcy context, for every claim that a Claimant may have against the Principal, the Principal may have backcharges, counter-claims for delay and other damages, and other defenses to the Claimant's claim. The Surety may use the defenses of its Principal as well as any defenses that the Surety may have under the payment bond.

Within the bankruptcy context, the Surety still maintains whatever Surety defenses it may have. The problems for the Surety arise when the Surety wants to settle a payment bond claim for an amount that involves a compromise between the Claimant's claim and the Debtor's defenses, and when the Surety attempts to settle or compromise an affirmative claim by the Debtor back against a Claimant and the Claimant's surety. In the first instance, the Debtor and others, including the Bank and the Committee, are interested in having as little paid out to the Claimant as possible, thereby reducing both the Claimant's claim against the Debtor and the Surety's claim for reimbursement from the Debtor. By reducing the amount of the claim, more of the Debtor's assets may be available for distribution to the Bank under its security interest and to unsecured creditors. The same situation exists in the second instance when the Surety attempts to settle the Debtor's affirmative claims against the Claimants and their sureties. Whether the Surety maintains an interest in the proceeds of any such settlement of an affirmative claim or not, the Bank and the Committee want to maximize the amount of recovery on every affirmative claim, either to reduce the ultimate claim of the Surety or to provide additional assets to the Debtor's estate for distribution to the Bank and the unsecured creditors.

In summary, the settlement of claims, whether they are the claims of the Claimants against the Debtor and the Surety for which there may be defenses or they are claims of the Debtor and the Surety against the Claimants and their sureties for other damages, create a conflict and an administrative hassle. There are ways that these conflicts may be reduced and/or eliminated.

A. The Surety's General Rights to Settle Claims Under the Indemnity Agreement.

The typical Surety indemnity agreement provides the following with respect to the settlement of various claims outside of the bankruptcy context.

1. Settlement of the Claimants' claims against the Principal and the Surety.

Frequently, the Surety's indemnity agreement allows the Surety to settle claims against the Surety and its bonds. A typical provision may say the following:

The Surety shall have the right, in its sole discretion, to defend, adjust, settle, compromise or pay, in whole or in part, any claim, counterclaim, demand, suit or judgment against it arising out of or in connection with any bonds.

In conjunction with such provisions in the Surety's indemnity agreement, the Surety may be entitled to demand cash or collateral from the Principal and the indemnitors if they request the Surety to defend against and/or litigate any claims or suits. The failure to provide such cash or collateral may allow the Surety to compromise any of the Principal's claims and defenses, including any counterclaim.¹²

2. The Surety's settlement of the Principal's affirmative claims.

Not only may the Surety have the right under the indemnity agreement to settle claims against its bonds, it may also have the right to settle the Principal's actions, causes of action and claims against other third parties, including subcontractors and suppliers and their sureties. For example, cases have held that the Surety may settle the affirmative claims of the Principal under the combined use of certain assignment rights and power of attorney rights found in the Surety's indemnity agreement. For example, the Surety's indemnity agreement may have the following provisions:

a. Assignment rights. (In the event that the Principal or the Indemnitors are in default of or in breach of their obligations under the bonds or the Indemnity Agreement, the Principal and the Indemnitors absolutely assign, convey and transfer to the Surety all of their rights and interest arising out of or in connection with the bonded contracts, including any actions, causes of action and claims the Principal or the Indemnitors may have against any person or entity.)

¹² Shahinian, Armen, *The General Agreement of Indemnity*, in *THE LAW OF SURETYSHIP*, 2D ED. (Edward G. Gallagher, ed. 2000), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION at pages 496 to 498.

b. Power-of-attorney rights. (The Principal and the Indemnitors irrevocably appoint the Surety as their attorney-in-fact with the right to exercise all of the rights of the Principal and the Indemnitors assigned, conveyed and transferred by the Indemnity Agreement, and in the name of the Principal and the Indemnitors to make, execute, endorse and deliver any and all documents, papers or other instruments deemed necessary and proper by the Surety in order to give full affect to the intent, meaning and purpose of the Indemnity Agreement.)

Through the use of the assignment rights and the power-of-attorney rights, the Surety may have the ability to settle the Principal's affirmative claims against third parties, including Claimants and their sureties.¹³

B. Bankruptcy Wrinkles to the Surety's Right to Settle Claims.

Under the normal claims process under the Bankruptcy Code when a Surety is not involved, an unsecured creditor will file a proof of claim against the Debtor under section 501 of the Bankruptcy Code and Bankruptcy Rules 3001, 3002 and/or 3003. An objection to the allowance of the claim may be filed in accordance with section 502 of the Bankruptcy Code and Bankruptcy Rule 3007. If the unsecured creditor and the Debtor reach a compromise or settlement of the controversy between them, Bankruptcy Rule 2002(a)(3) requires a 20 day notice to all parties in interest in the case, including the Debtor, the Committee and other interested parties, prior to the settlement of the claim. Such a notice is also required for any compromise or settlement under Rule 9019 concerning contested matters.

Sureties are very experienced in reviewing the claims of Claimants and negotiating settlements with Claimants. In order to expedite the claims-handling process, and allow the speedy resolution of many typical payment bond disputes, it is advisable for the Surety and the Debtor to agree to a procedure that will allow the prompt settlement of the Claimants' claims against the payment bonds even if it means the settlement of certain disputes without notice to all interested parties and possible hearings on the settlements.

The settlement of the Debtor's affirmative claims that may generate additional assets for the Debtor's estate may be a more difficult proposition because of the interest of the Bank, the Committee, and others in maximizing the assets of the Debtor's estate for distribution under the plan of reorganization. It is doubtful that a Surety will be able to compromise the Debtor's affirmative claims without some notice through the Bankruptcy Court to interested parties, and approval by the Bankruptcy Court after the opportunity for a hearing.

Attached as Exhibit 2 is a draft of proposed language that may be contained in any cash collateral order or financing order that would outline the rights of the Surety to settle the claims of the Claimants under the payment bond and set forth the obligations and procedures with respect to the Surety's settlement of any of the Debtor's affirmative claims.

¹³ *Id.* at pages 500 to 508.

IV. The Debtor's or Trustee's Preference Actions Against the Claimants for Their Pre-Petition Receipt of Payments from the Debtor

So far, this paper has dealt with prospective events after the Debtor's filing of its bankruptcy case, namely the processing and payment of the pre-petition and post-petition claims of the Claimants and the settlement of any disputes with respect to those claims that will allow whatever payments to be made. The proactive concepts discussed above are aimed at allowing the Debtor and the Surety to pay both the pre-petition and post-petition claims of the Claimants in order to have them continue to perform the work and supply the materials necessary for the completion of the bonded contracts. The preference issue, however, is definitely a retrospective issue that arises when the Debtor, its Trustee in the event that the Debtor's case is converted to a chapter 7 or a chapter 11 trustee is appointed, or some other interested party such as a Committee under a plan of reorganization decide to review the payments made by the Debtor within 90 days of the Debtor's petition date to determine whether any preferential payments have been made to the Claimants, including pre-petition payments to the Claimants for work performed and materials supplied on the bonded contracts.

Section 547 of the Bankruptcy Code provides preference avoidance powers to the Debtor or the Trustee. The necessary elements of a preference action are:¹⁴

1. A transfer must be made.
2. The transfer must be property of the Debtor.
3. The transfer must be to or for the benefit of a creditor.
4. The transfer must be for or on account of an antecedent debt owed by the Debtor before the transfer was made.
5. The transfer must have been made while the Debtor was insolvent.
6. The transfer must have been during the 90 days immediately preceding the commencement of the case. If the transfer was made to an insider, the transfer may be avoided for the additional period that begins one year before the filing of the petition and ends 90 days before the filing.
7. The transfer must enable the creditor, to or for whose benefit it was made, to receive a greater percentage of its claim than it would receive under the distributive provisions of the Bankruptcy Code, In other words, the creditor must receive more than it would have received if the payments had not been made and the creditor received what it would in a chapter 7 liquidation.

Section 547(c) of the Bankruptcy Code provides certain defenses to the Debtor's or the Trustee's claim of preference, including, for the purposes of the Claimant and/or the Surety:

1. A contemporaneous exchange for new value [section 547(c)(1)];
2. Some new value given after such a transfer [section 547(c)(4)]; and
3. The payment is made in the ordinary course of business [section 547(c)(2)].

¹⁴ 11 U.S.C. § 547(b). Schexnayder, Chad L., *Bankruptcy and the Surety*, in THE LAW OF SURETYSHIP, 2D ED. (Edward G. Gallagher, ed. 2000), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION at page 357 and Schexnayder, Chad L., *Bankruptcy*, in THE LAW OF PAYMENT BONDS (Kevin L. Lybeck and H. Bruce Shreves, eds. 1998), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION at page 315.

So much has been written recently concerning the potential claims of a Debtor or Trustee against the Claimant for a preference and/or against the Surety for an indirect preference that these comprehensive and well-written resources should be reviewed.¹⁵ This paper has no intention of reinventing the good work of others. However, the authors suggest that under the appropriate circumstances, there is a means for avoiding the preference issues and also other potential claims by the Debtor, the Trustee, the Committee and/or others that may increase the Surety's loss at a time when the Surety is attempting to mitigate the loss of all parties.

If the Surety agrees to the Debtor's use of the bonded contract funds as cash collateral and/or agrees to finance the Debtor during its chapter 11 bankruptcy case and advance funds for the payment of the Claimants for pre-petition and post-petition claims as well as other costs and expenses of the Debtor in proceeding towards the performance and the completion of the bonded contracts, the Surety should require, as part of its adequate protection for allowing the Debtor to use the bonded contract funds as cash collateral and for the post-petition financing, the elimination of any potential preference actions against the Claimants, and the Surety, as a result of pre-petition payments that the Claimants have received from the Debtor. If it is in the best interests of the Debtor, the Surety, the Bank and the Committee, as the representative of all of the unsecured creditors, to proceed with the completion of the performance of the work by the Debtor as a result of the Surety's financing, all interested parties should agree that the Claimants, who would otherwise probably be the major unsecured creditors in the Debtor's case, should be protected from preference actions as a result of any pre-petition payments from the Debtor.

The following is a draft of a provision that should be placed in a cash collateral order and/or a financing order between the Debtor and the Surety that, as a part of the adequate protection and consideration to the Surety for the Surety's consent to the Debtor's use of the bonded contract funds as cash collateral and for the Surety's advancing funds to the Debtor, eliminates any preference actions against the Claimants for pre-petition payments from the Debtor.

The Debtor, the Committee, any other party in interest, and any chapter 11 or chapter 7 Trustee are hereby forever barred from commencing or prosecuting any avoidance action under § 547 of the Bankruptcy Code against any subcontractor and/or supplier to the Debtor to recover a pre-petition payment or payments from the Debtor for work performed and/or materials supplied on or to any of the bonded contracts, including but not limited to any such subcontractor and/or supplier for work

¹⁵ Schexnayder, Chad L., *Bankruptcy and the Surety*, in THE LAW OF SURETYSHIP, 2D ED. (Edward G. Gallagher, ed. 2000), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION; Mann, Jay M. and Berens, Robert J., *Deciding to Litigate: In the Bankruptcy Court*, in MANAGING AND LITIGATING THE COMPLEX SURETY CASE (Philip L. Bruner, ed. 1998), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION; Schexnayder, Chad L., *Bankruptcy*, in THE LAW OF PAYMENT BONDS (Kevin L. Lybeck and H. Bruce Shreves, eds. 1998), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION; Berens, Robert J., *Bankruptcy: Can a Surety be Held Liable for the Prepetition Payments Made by its Principal?* (unpublished paper submitted at the ABA annual meeting on August 10, 1993).

performed and/or materials supplied on or to any of the bonded contracts who may have or may have had a claim against any of the bonds executed by the Surety; and it is further provided that the Surety shall not be liable under §§ 547 and/or 550 of the Bankruptcy Code as a beneficiary of any such pre-petition payments by the Debtor to subcontractors and suppliers for work performed and/or materials supplied on or to any of the bonded contracts.

Such a provision should eliminate any preference actions against the Claimants, and help the Surety avoid potential claims from the Claimants who might otherwise be required to disgorge their receipt of a pre-petition payment from the Principal/Debtor as a preferential payment.

V. Summary and Conclusion

This paper has not attempted to address all of the issues involving a payment bond surety and the claims of subcontractors and suppliers to the surety's principal when the principal files its bankruptcy case. A recent article has addressed many of these issues and other issues not covered by this paper, including whether the automatic stay affects a claim by a subcontractor or supplier against the surety's payment bond, certain statute of limitations issues, the bonded contract funds as property of the debtor's estate, and certain setoff and recoupment defenses.¹⁶ Rather, we have attempted to address certain practical problems in handling payment bond claims at the inception of the principal's bankruptcy case, including the payment of the claims, the settlement of the claims, and how to avoid preference suits against the subcontractors, the suppliers and the surety. We hope that our suggestions will prove valuable to you in the handling of payment bond claims in the future in the unfortunate event of your principal's filing of a bankruptcy case.

¹⁶ Schexnayder, Chad L., *Bankruptcy*, in THE LAW OF PAYMENT BONDS (Kevin L. Lybeck and H. Bruce Shreves, eds. 1998), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION.

EXHIBIT 1

The Definition and Use of the Pre-Petition Bonded Contract Funds and the Post-Petition Bonded Contract Funds for the Payment of the Pre-Petition Bonded Contract Claims and the Post-Petition Bonded Contract Claims

1. The Debtor and the Surety agree, with the consent of the Committee, as follows with respect to the use of the pre-petition and post-petition bonded contract funds for the payment of the pre-petition and post-petition claims of the Debtor's subcontractors and suppliers on the bonded contracts (the "Claimants") and for the reimbursement of the Surety for its payment of the pre-petition and post-petition claims of the Claimants.

2. The following terms shall have the following meanings:

(a) The "Pre-Petition Bonded Contract Funds" shall mean any and all payments of bonded contract funds to the Debtor from the obligees on the bonded contracts for work performed and/or materials supplied by the Debtor and/or the Claimants on or before _____ (the "Debtor's Petition Date"). In order for the payments from the obligees on the bonded contracts to constitute "Pre-Petition Bonded Contract Funds," all of the work performed and/or materials supplied by the Debtor and/or the Claimants for which the payment of the bonded contract funds is being made to the Debtor must have occurred on or before Debtor's Petition Date.

(b) The "Post-Petition Bonded Contract Funds" shall mean any and all payments of bonded contract funds to the Debtor from the obligees on the bonded contracts for work performed and/or materials supplied by the Debtor and/or the Claimants on or after the Debtor's Petition Date. In the event that any of the work performed and/or materials supplied by the Debtor and/or the Claimants occurs on or after the Debtor's Petition Date, and such work performed and/or materials supplied is paid for by part of the bonded contract funds, the entirety of the bonded contract funds paid shall be deemed to be "Post-Petition Bonded Contract Funds" notwithstanding the fact that the payment or payments may be in part for work performed and/or materials supplied prior to the Debtor's Petition Date and in part for work performed and/or materials supplied after the Debtor's Petition Date. Any and all retainage payments made by the obligees to the Debtor on the bonded contracts after the Debtor's Petition Date shall be deemed, in their entirety, to be "Post-Petition Bonded Contract Funds."

(c) The "Pre-Petition Bonded Contract Claims" shall mean any and all claims by the Claimants for work performed and/or materials supplied to the Debtor on the bonded contracts which occurred entirely for work performed and/or materials supplied on or before the Debtor's Petition Date.

(d) The "Post-Petition Bonded Contract Claims" shall mean any and all claims by the Claimants for work performed and/or materials supplied to the Debtor on the bonded contracts which occurred for work performed and/or materials supplied either on or after the

Debtor's Petition Date or for work performed and/or materials supplied in part prior to the Debtor's Petition Date and in part after the Debtor's Petition Date. Any and all claims made by the Claimant's for retainage on the bonded contracts after the Debtor's Petition Date shall be deemed, in their entirety, to be "Post-Petition Bonded Contract Claims."

3. The Debtor and the Surety may use the Pre-Petition Bonded Contract Funds to pay the Pre-Petition Bonded Contract Claims. In the event that the Surety has paid the Pre-Petition Bonded Contract Claims, the Surety shall be reimbursed from the Pre-Petition Bonded Contract Funds for all amounts paid by the Surety for the Pre-Petition Bonded Contract Claims, whether the Surety has paid or will pay the Pre-Petition Bonded Contract Claims through any direct payments made by the Surety or any payments made from the Surety's post-petition financing of the Debtor to pay any Pre-Petition Bonded Contract Claims.

4. The Debtor and the Surety may use the Post-Petition Bonded Contract Funds to pay the Post-Petition Bonded Contract Claims. In the event that the Surety has paid the Post-Petition Bonded Contract Claims, the Surety shall be reimbursed from the Post-Petition Bonded Contract Funds.

5. In the event that the Pre-Petition Bonded Contract Funds are insufficient to pay the Debtor's Pre-Petition Bonded Contract Claims and to reimburse the Surety for its payment of the Debtor's Pre-Petition Bonded Contract Claims (the "Pre-Petition Deficiency"), the Pre-Petition Deficiency shall become a part of the Surety's pre-petition claim.

6. In the event that the Pre-Petition Bonded Contract Funds are in excess of the amounts paid for the Debtor's Pre-Petition Bonded Contract Claims and the amounts necessary to reimburse the Surety for the Surety's payment of the Debtor's Pre-Petition Bonded Contract Claims (the "Excess Pre-Petition Bonded Contract Funds"), the Excess Pre-Petition Bonded Contract Funds shall be applied to the payment of the Debtor's Post-Petition Bonded Contract Claims, including the reimbursement of the Surety for its payment of any of the Debtor's Post-Petition Bonded Contract Claims.

7. In the event that the Post-Petition Bonded Contract Funds are insufficient to pay the Debtor's Post-Petition Bonded Contract Claims and to reimburse the Surety for its payment of the Debtor's Post-Petition Bonded Contract Claims (the "Post-Petition Deficiency"), the Post-Petition Deficiency shall become a part of the Surety's post-petition claim against any collateral provided by the Debtor to the Surety, and an administrative expense claim under the Bankruptcy Code for any remaining Post-Petition Deficiency.

8. In the event that the Post-Petition Bonded Contract Funds are in excess of the amounts paid for the Debtor's Post-Petition Bonded Contract Claims and the amounts necessary to reimburse the Surety for the Surety's payment of the Debtor's Post-Petition Bonded Contract Claims (the "Excess Post-Petition Bonded Contract Funds"), the Excess Post-Petition Bonded Contract Funds, as determined from time to time, shall be applied to the Surety's Pre-Petition Deficiency, if any.

EXHIBIT 2

The Surety's Settlement of the Claimants' Claims Against the Debtor and the Surety and the Debtor's Affirmative Claims Against the Claimants and Their Sureties

Pursuant to the terms of the Indemnity Agreement, the Surety is authorized to negotiate and shall have full authority to settle claims by subcontractors and suppliers against the Debtor and the payment bonds issued on the bonded contracts. The settlement of such claims may involve the settlement or compromise of a controversy by the Surety that relates to a defense of the Debtor to its payment obligation to such subcontractors and/or suppliers, and may include the settlement of any backcharges, setoffs or other affirmative claims of the Debtor against such subcontractors and/or suppliers if the amount of the backcharges, setoffs or other affirmative claims against any such subcontractor and/or supplier on a bonded contract are less than the amount claimed by the subcontractor and/or supplier against the Debtor and the payment bond issued on the bonded contract. The Debtor hereby consents to and authorizes the Surety's settlement of such claims by subcontractors and suppliers and, in accordance with Bankruptcy Rules 2002 and 9019(b), no further notice or hearing shall be required to sanction the Surety's settlement or compromise of such claims by subcontractors and suppliers.

The Surety's settlement rights under this agreement do not extend to any affirmative claims that the Debtor may have against any subcontractors and/or suppliers that are greater than the claim that the subcontractors and/or suppliers may have against the Debtor and the payment bond issued on the bonded contracts (the "Affirmative Claims"), and all such Affirmative Claims must be settled in accordance with the provisions of the Bankruptcy Code and the Bankruptcy Rules.

The Debtor, and the Surety, as necessary, shall provide to the Committee any documents reasonably requested by the Committee concerning the Surety's settlement of claims.

To the extent necessary for the Surety to implement the provisions of this agreement, the automatic stay of § 362 of the Bankruptcy Code is hereby vacated.

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