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THE SURETY'S RIGHT/NEED TO RETAIN COLLATERAL AFTER RELEASE OF BOND LIABILITY: REVIVAL OF SURETY'S LIABILITY AND AVOIDING BANKRUPTCY PITFALLS

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INTRODUCTION

The surety can obtain collateral from the principal before, and as a condition of, writing bonds as an underwriting measure. The surety may also, or alternatively, demand collateral upon the receipt of claims pursuant to its contractual and common law rights to exoneration and indemnification as part of the claims handling process. In either case, the availability of collateral may determine whether or not the surety takes a loss on its guaranty of the bonded principal's obligations, and the surety will want to retain its collateral for as long as it is at risk. When the principal has discharged the bonded obligations, it will conclude that the surety's liability has ended and will therefore seek the return of the collateral. In most cases, the surety will agree with that assessment and comply with the principal's request. Sometimes, however, the principal will be in financial distress even if it is able to satisfy its obligations. The prospect of liquidation or reorganization under the federal Bankruptcy Code or state insolvency statutes looms. In those instances, the surety may be reluctant to release the collateral, even if only on "general principles." There is good reason, however, for the surety to be concerned: The obligee may be forced to return a payment made by an insolvent principal shortly before filing bankruptcy. If that occurs, then under what one court has called "a somewhat obscure doctrine,"[2] liability that the surety thought had been discharged by the principal's performance will be revived and the obligee will be able to recover the disgorged payment from the surety.

If such a revival of liability is even remotely possible, the surety will quite naturally want to retain any collateral which it is fortunate enough to hold until its liability is permanently interred. The problem is that some courts have imposed upon the surety significant damages, including consequential and punitive damages, for conversion of the principal's collateral when the surety has held it after claims against the bond were no longer reasonably possible. Clearly, the surety needs to know when it has a right to hold collateral and when it does not. The first step is to understand the "obscure doctrine" by which the surety's liability can be revived when the obligee is forced to retain the principal's payment as a preference, and that doctrine is reviewed in Part I of this paper. Part II addresses the circumstances under which

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[1] The authors thank Graham Claybrook of Wolff & Samson PC for his substantial assistance with the research and preparation of this paper.

[2] Centre Ins. Co. v. SNTL Corp. (*In re* SNTL Corp.), 380 B.R. 204, 207 (B.A.P.9th Cir. 2007).

the law of conversion may be applied to the surety who refuses to release collateral. Lastly, Part III considers possible strategies for avoiding or at least minimizing the pitfalls that line the path of the surety who wishes to retain collateral when the principal has petitioned for protection under the Bankruptcy Code or state insolvency statutes.

I. REVIVAL OF THE SURETY'S LIABILITY AFTER RELEASE OF BOND LIABILITY

The principal's performance of the bonded obligation — such as, for example, payment of a guaranteed debt — normally discharges the surety's secondary liability for doing so.[3] However, the universally applied rule is that the surety's obligation is revived if the obligee, creditor, or other bond beneficiary is compelled to return the payment or other performance made by the principal to satisfy the bonded obligation.[4] As one court put it, "[a] preferential payment is deemed by law to be no payment at all."[5] The Restatement (Third) of Suretyship and Guaranty agrees:

> When a secondary obligation is discharged in whole or part by performance by the principal obligor or another secondary obligor, or by realization upon collateral securing such performance, the secondary obligation revives to the extent that the obligee, under a legal duty to do so, later surrenders that performance or collateral, or the value thereof, as a preference or otherwise.[6]

When the surety or guarantor satisfies the principal's obligations, the surety becomes entitled to reimbursement from the principal and thereby is substituted as the creditor of the principal.[7] Thus, a payment by the debtor to the creditor discharges the guarantor's contingent obligation to make that payment. Such a discharge is regarded as the functional equivalent of

[3] Herman Cantor Corp. v. Cent. Fid. Bank, N.A. (*In re* Herman Cantor Corp.), 15 B.R. 747, 750 (Bankr. E.D. Va. 1984); *cf.* RESTATEMENT OF SURETYSHIP & GUAR. § 1(2)(a) (1996) (an obligee has recourse against a secondary obligor with respect to an underlying obligation whenever "the principal obligor owes performance of the underlying obligation").

[4] *E.g.*, Wallace Hardware Co. v. Abrams, 223 F.3d 382, 408 (6th Cir. 2000) ("[T]he courts have uniformly held that a payment of a debt that is later set aside as an avoidable preference does not discharge a guarantor of his obligation to repay that debt."); Centre Ins. Co. v. SNTL Corp. (*In re* SNTL Corp.), 380 B.R. 204, 213-14 (B.A.P.9th Cir. 2007) (noting that party opposing revival was unable to cite a single case holding that the surety's liability is not revived by the return of a preferential payment); Lowrey v. Mfrs. Hanover Trust Leasing Corp. (*In re* Robinson Drilling, Inc.), 6 F.3d 701, 704 (10th Cir. 1993); Fenold v. Green, 175 F.2d 247, 249 (2d Cir. 1949); *Herman Cantor Corp.*, 15 B.R. at 750; Horner v. First Nat'l Bank, 141 S.E. 767, 770 (Va. 1928).

[5] *Herman Cantor Corp.*, 15 B.R. at 750.

[6] RESTATEMENT (THIRD) OF SURETYSHIP & GUAR. § 70 (1996); *accord* 72 C.J.S. *Principal & Sur.* § 129 (Updated 2009).

[7] RESTATEMENT (THIRD) OF SURETYSHIP & GUAR. § 22(1) cmt. a ("When the principal obligor is charged with notice of the secondary obligation, the duty to reimburse, like the principal obligor's duty to perform, arises from implied contract ….[T]he principal obligor … agrees that it will reimburse the secondary obligor to the extent that the secondary obligor does perform, thereby fulfilling all or part of the underlying obligation.").

a payment to the creditor and therefore is subject to avoidance as an indirect preference.[8] In *Horner v. First National Bank*,[9] the court imagined the consequences for banks if preferential payments could discharge the surety as follows:

> They would in fear and trembling receive payment from harassed debtors striving to maintain their credit. When to take and when to refuse would be beyond the wisdom of man, for not all who are financially embarrassed fail, and not all who fail do so within the magic period of four months. Must a bank say to a customer, "You seem to be in trouble, and I cannot permit you to pay me; I might perchance have to refund to some trustee in bankruptcy and so lose the security of your indorsers."[10]

The concept of a "preferential payment" and the power to compel its return are creatures of insolvency statutes and were created so that all creditors might share the insolvent debtor's assets equally[11] by preventing aggressive creditors from improving their position in the period immediately preceding the bankruptcy when the debtor is presumed to be particularly vulnerable.[12] Due to its general availability and national scope, the United States Bankruptcy Code[13] is the most widely applied insolvency statute, and hence its preference provision is undoubtedly the most often used. That provision, 11 U.S.C. § 547(b),[14] authorizes the bankruptcy trustee to obtain the return of payments made by the debtor as follows:

> **(b)** Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property —
>
> **(1)** to or for the benefit of a creditor;
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> **(2)** for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> **(3)** made while the debtor was insolvent;

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[8] *Herman Cantor Corp.*, 15 B.R. at 749 (citing Fenold v. Green, 175 F.2d 247, 249 (2d Cir. 1949)).

[9] 141 S.E. 767 (Va. 1928).

[10] *Id.* at 770 (quoted in *Herman Cantor Corp.*, 15 B.R. at 750).

[11] *See, e.g.*, WILLIAM L. NORTON III & ROGER G JONES, NORTON CREDITORS' RIGHTS HANDBOOK, 2008 EDITION § 11:5 at 337-38 (Thompson/West 2008) (discussing rationale of preference provisions of the federal Bankruptcy Code).

[12] Subsection (f) of § 547 provides that "[f]or the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition. 11U.S.C.A. § 547(f) (West 2004).

[13] 11 U.S.C. § § 1-1532 (West 2004 & Supp. 2009)

[14] 11 U.S.C.A. § 547(b) (West 2004 & Supp. 2009)

(4) made —

(A) on or within 90 days before the date of the filing of the petition [for bankruptcy]; or

(b) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was in insider; and

(5) that enables such creditor to receive more than such creditor would receive if —

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.[15]

Thus, under the Bankruptcy Code, if an insolvent principal makes a payment to an obligee on a existing obligation within 90 days prior to filing bankruptcy (or within one year prior to filing if the obligee is an insider of the principal) with the result that the obligee thereby receives a greater benefit than it would have received in a bankruptcy liquidation of the principal's assets, the trustee may thereafter force the obligee to disgorge that payment.[16] The surety is exposed to the possibility of revival of liability by avoidance of preferential transfers for up to 90 days prior to filing and up to a year for payments to an insider.[17]

The effect upon the surety of the disgorgement of a preferential payment under § 547(b) is illustrated in *Wallace Hardware Co. v. Abrams*.[18] In that case, a hardware wholesaler sold a substantial amount of goods and services to a start-up retailer on credit. The president of the retailer and his brother, who provided financing for the venture, guaranteed to the wholesaler the payment of all indebtedness of the retailer. The retailer failed and closed its doors within three months which resulted in state court litigation between the wholesaler and retailer. That litigation was settled by a consent order authorizing the wholesaler to repossess the inventory it had sold to the retailer and to credit the retailer's account accordingly. The wholesaler repossessed the inventory for which it credited the retailer approximately $780,000 which left a

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[15] *Id.*

[16] Not all transfers that fit within subsection (b) of § 547 are subject to avoidance as preferences. Subsections (c) and (i) of § 547 exempt payments made for certain purposes or under certain circumstances. The extent to which the surety may be able to use those exceptions to contest the trustee's preference claim and hence avoid the revival of its liability is discussed *infra* Part III.B.2.

[17] *See infra* note 95 for a definition of an "insider."

[18] 223 F.3d 382 (6th Cir. 2000).

balance of $146,000. Just under 90 days later, other creditors of the retailer commenced an involuntary liquidation proceeding against the retailer under Chapter 7 of the Bankruptcy Code.[19] The trustee for the retailer then sought to compel the wholesaler to return the inventory to the retailer's estate on the grounds that the repossession was a preferential transfer that was avoidable under § 547(b).[20] The trustee and the wholesaler entered into a settlement agreement pursuant to which the wholesaler paid $128,000 to the trustee in full accord and satisfaction of all claims of the trustee against the wholesaler.

The wholesaler then sued the guarantors for damages which included the $128,000 paid to the retailer's bankruptcy trustee. In granting summary judgment to the guarantors, the district court ruled that the doctrine of accord and satisfaction precluded the wholesaler from recovering that payment.[21] On appeal, the Sixth Circuit reversed, ruling that "a guarantor's liability is commensurate with the outstanding indebtedness of the principal debtor"[22] and that because the bankruptcy trustee's preferential transfer claim prevented the wholesaler from retaining the full value of the retained inventory, the net amount of the retailer's debt included the $128,000 paid to the trustee. In effect, the court held that amounts disgorged by the creditor as preferential transfers are included in the calculation of the amount of the guaranteed indebtedness.[23] The court noted that "the outcome here would seem to be dictated by the very nature of an 'avoidable' preferential transfer under the § 547 of the Bankruptcy Code" and that "[n]ot surprisingly, the courts have uniformly held that payment of a debt that is later set aside as an avoidable preference does not discharge a guarantor of his obligation to repay the debt."[24] The court quickly disposed of the district court's reasoning on the ground that an accord and satisfaction was a contract and "like any other contract could be set aside, in whole or in part, for such reasons as mutual mistake, supervening illegality or frustration of purpose."[25]

Although the surety may be most frequently exposed to the potential revival of liability through the operation of § 547(b), state insurance and banking insolvency and conservation statutes also typically authorize the recapture of preferential transfers and sureties have seen their liability revived as a result of the operation of such statutes.[26] In *Centre Insurance Co. v. SNTL Corp. (In re SNTL Corp.)*,[27] for example, the Ninth Circuit Bankruptcy Appellate Panel

[19] 11 U.S.C.A. § 303 (West 2004 & Supp. 2009)

[20] *Wallace Hardware*, 223 F.3d at 388.

[21] *Id.* at 390.

[22] *Id.* at 407.

[23] *Id.* at 407-08.

[24] *Id.* at 408.

[25] *Id.* at 408.

[26] Insurance companies and banks are expressly excluded from Chapter 7 of the Bankruptcy Code, 11 U.S.C.A. § 109(b)(2) (West Supp. 2009), and Chapter 11 of the Bankruptcy Code, 11 U.S.C.A. § 109(d) (West Supp. 2009), and as a result insolvency of insurance companies and banks are administered under state statutes.

[27] 380 B.R. 204 (B.A.P.9th Cir. 2007).

recently considered whether the guarantor's obligation was revived when the obligee returned a multi-million dollar payment pursuant to California insurance company liquidation statutes. In that "complicated and high-stakes case,"[28] a corporation guaranteed the obligations of its insurance company affiliates under a reinsurance treaty and fronting agreements between the affiliates and another insurance company. When the affiliates breached those obligations, the guarantor paid $163.4 million to the creditor insurance company, and the creditor signed a settlement agreement which expressly released the guarantor. Three months later, the California Insurance Commissioner placed the guarantor's affiliates into conservation and then liquidation under California insurance statutes.[29] The insurance commissioner sued the creditor insurance company in a California state court seeking to recover as an avoidable preference under the provisions of the California Insurance Code[30] the $163.4 million paid by the guarantor. The commissioner's claim was ultimately settled by the creditor's payment to the commissioner of $110 million as a partial return of the payment made by the guarantor.

Meanwhile the guarantor filed a Chapter 11 petition for relief under the Bankruptcy Code. In that proceeding, the creditor asserted a claim against the guarantor which included the $110 million which the creditor paid to the insurance commissioner. The bankruptcy court ruled against the creditor on the ground that the $110 million was paid after the guarantor filed its petition and that therefore any resulting revival of the guarantor's liability constituted a non-allowable postpetition claim.[31] On appeal the Ninth Circuit's Bankruptcy Appeal Panel reversed, ruling that the creditor's guaranty claim was subject to revival upon the commencement of the California conservatorship which occurred before the guarantor filed its bankruptcy petition and that therefore the claim was allowable as prepetition contingent claim.

In reaching that conclusion, the panel applied "a somewhat obscure doctrine that involves the intersection of insolvency law principles and guaranty law, illustrating the temporal nature of a release of a guarantor when a voidable preference is recovered from the obligee"[32] to hold "that the return of a preferential payment by a creditor generally revives the liability of the creditor" even though it found no Ninth Circuit or California case on point.[33] The court followed and applied the *Wallace Hardware* case[34] even though the preferential payment was disgorged under § 547(b) while the preference claim against guarantor arose under state law because the general rule of revival of the guarantor's liability "should operate with equal force

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[28] *Id.* at 207.

[29] *See* Cal. Ins. Code § 1010, *et seq.* (West 2009).

[30] Cal. Ins. Code § 1034(c)(1) (West 2009).

[31] 11 U.S.C.A. § 502(b) (West 2004).

[32] *Centre Ins. Co.*, 380 B.R. at 207.

[33] *Id.* at 213.

[34] Wallace Hardware Co. v. Abrams, 223 F.3d 382 (6th Cir. 2000). The bankruptcy appellate panel also cited *Lowrey v. Manufacturers Hanover Leasing Corp. (In re Robinson Drilling, Inc.)*, 6 F3d 701 (10th Cir. 1993), *Herman Cantor Corp. v Central Fidelity Bank (In re Herman Cantor Corp.)*, 15 B.R. 747 (Bankr. E.D. Va. 1981), RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 70 (1996), and 72 C.J.S. *Principal and Surety* § 129 (1955, Updated 2009). 380 B.R. at 213-14.

whatever preference law applies."[35] The court rejected the argument that the general rule should not be applied because the creditor returned the payment pursuant to a settlement agreement and therefore was not involuntary. While acknowledging that secondary authorities state that the repayment be compelled,[36] the court noted that in *Wallace Hardware*, the court held that the guarantor's liability was revived when creditor returned the payment in settlement of the preference claim. The court quoted and agreed with the following statement in an unpublished opinion of "[a] state appellate court": "'We do not regard the settlement as uncoerced. A lawsuit necessarily implies a degree of compulsion. A payment made in settlement of contested litigation is not truly voluntarily.'"[37]

State insolvency statutes have different preference periods, including some as long as a year,[38] or as short as four months.[39] Accordingly, the surety concerned about the possible revival of its liability upon disgorgement of a preferential payment should identify the applicable insolvency statutes. As noted, the Bankruptcy Code, with its 90-day and one-year preference periods, will generally govern preferential transfers by most individuals and business entities, while state laws will govern the liquidation of insurance companies and banks. However, the principle that the surety's obligation is revived when an obligee must return a preferential payment applies regardless of whether the principal's insolvency arises under state or federal law.[40]

There may also be differences between the Bankruptcy Code and state insolvency statutes as to the period of time within which an action to avoid a preferential transfer may be brought. Under the Bankruptcy Code, an avoidable preference action must be brought either within two years after the date of the bankruptcy petition or one year after the appointment or

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[35] *Centre Ins. Co.*, 380 B.R. at 214 n.11. Other courts have agreed, *see* Ario v. Ingram Micro, Inc., 965 A.2d 1194 (Pa. 2009) ("Use of federal bankruptcy law for guidance in interpreting ambiguous state insurance insolvency law is commonly accepted.") (citing Wilcox v. CSX Corp., 70 P.3d 85, 91 (Utah 2003)).

[36] RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 70 ("[T]he secondary obligation revives to the extent that the obligee, under a legal duty to do so, later surrenders that performance or collateral, or the value thereof, as a preference or otherwise."); 72 C.J.S. *Principal and Surety* § 129 ("[I]f the creditor is forced to refund the payment, the surety's liability is restored.").

[37] *Centre Ins. Co.*, 380 B.R. at 214 n.10 (quoting unpublished opinion) (emphasis omitted).

[38] *See, e.g.*, Cal. Ins. Code § 1034(c)(1) (West 2009) (creditor must return a transfer made by an insurance company within one year of its liquidation by the state when the creditor had reasonable cause to believe that the insurer was insolvent or was about to become insolvent); N.C. Gen. Stat. § 58-30-150 (West 2009) (trustee may avoid transfers made within one year of the filing of a successful petition for liquidation if the creditor had reasonable cause to believe that the insurer was insolvent or was about to become insolvent; or within four months regardless of the creditor's culpability).

[39] *See, e.g.*, Del. Code Ann., tit. 18 § 5925 (West 2009) (any transfer of or lien upon property of an insurer within four months before liquidation proceedings are successfully commenced, made with the intent of giving a preference or advantage to any creditor, are voidable by the trustee).

[40] *See Centre Ins. Co.*, 380 B.R. at 214 n. 11 ("Nonetheless, the general principle – that the return of a preferential payment of a primary obligor by the obligee revives a guarantor's obligation otherwise released by that payment – should operate with equal force whatever preference law applies."); *see also Ario*, 965 A.2d at 1194 ("Use of federal bankruptcy law for guidance in interpreting ambiguous state insurance insolvency law is commonly accepted.").

election of the first trustee, whichever is later.[41] By contrast, under the California statute governing insurance company liquidations, for example, preference claims can be brought at any time within three years of the filing of the liquidation petition.[42] To protect itself when the principal has discharged the bonded obligation within the preference period, therefore, the surety will want to hold collateral for the length of the applicable limitations period. The question is, may it do so?

II. THE SURETY'S LIABILITY FOR CONVERSION BY WRONGFULLY RETAINING COLLATERAL

The major limitation on the surety's right to hold collateral after the initial satisfaction of the bonded obligation is the law of conversion. It is stated as a general rule that "[a] secured creditor commits conversion if it retains possession of the collateral when it has no right to do so and refuses to surrender it to the debtor."[43] That rule has been applied to the retention of collateral by sureties, though there are only a few reported cases.[44] Those cases seem to agree that if there is an indemnity agreement or collateral security agreement which addresses the issue, its terms will be enforced.[45] Even so, the courts will say that the surety must exercise its contractual rights reasonably, in good faith, or both.[46] The issue decided by the cases is whether under the governing instrument, the surety is entitled to retain the collateral in the existing circumstances, and that issue essentially boils down to whether the surety remains at risk on the bonds. In reading the cases, it is hard to avoid the conclusion that that if the surety retains the collateral past the time when the court thinks bond liability has ended, the surety will be held to have converted the principal's collateral. Of course, that judgment is made after the fact when the judge or jury knows how the story turned out, while the surety had to make its decision before the outcome was known.

Conversion is a matter of common law. The traditionally accepted formulation defines conversion as "'[a]ny distinct act of dominion, wrongfully exerted over one's property in denial of his right or inconsistent with it.'"[47] The problem is that "the definition is too abstract to

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[41] 11 U.S.C. § 546(a)(1) (West 2004). Regardless of which of these dates is later, the action must be brought before the bankruptcy case is closed or dismissed. *Id.*

[42] Low v. Lan, 96 Cal. App. 4th 1371, 1382 (Cal. App. 2002) (citing Cal. Code Civ. P. § 338(a)).

[43] 68A AM. JUR. 2D *Secured Transactions* § 693 (2003) (citation omitted); *see also id.* § 488 ("When the debt for which the collateral was assigned as security is discharged, the creditor must return the collateral to the debtor. Failure to do so is a conversion." (citations omitted)).

[44] *See, e.g.,* Pittston Warehouse Corp. v. Am. Motorists Ins. Co., 715 F.Supp. 1221 (S.D.N.Y. 1989); Harrell v. Anderson, 294 F. Supp. 405 (S.D. Ga. 1958); Luzar v. W. Sur. Co., 692 P.2d 337 (Idaho 1984); Nora v. Safeco Ins. Co., 577 P.2d 347 (Idaho 1978).

[45] *See, e.g., Pittston Warehouse*, 715 F. Supp. at 1226; *Luzar*, 692 P.2d at 340. No reported case has directly dealt with collateral that was provided to the surety in the absence of a written agreement. As it is unlikely that the principal will have deposited collateral without at least some understanding as to its use and disposition, courts would likely address the issues under implied-in-fact or quasi contract theories.

[46] *See id.* at 1225; *Luzar*, 692 P.2d at 340.

[47] 1 DAN B. DOBBS, THE LAW OF TORTS § 64 at 136 (2001) (quoting THOMAS M. COOLEY, LAW OF TORTS 448 (1878) and stating that "[m]any courts have stated this formula or some variation on it." (citations omitted)).

furnish a strong guide to attorneys who must seek useful evidence and formulate arguments."[48] The Restatement (Second) of Torts seeks to be more concrete. It offers the following definition:

> Conversion is an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel.[49]

The Restatement then lists the following six "important" factors to be considered "in determining the seriousness of the interference and the justice of requiring the actor to pay full value, … ":

> (a) the extent and duration of the actor's exercise of dominion or control;
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> (b) the actor's intent to assert a right in fact inconsistent with the other's right of control;
>
> (c) the actor's good faith;
>
> (d) the extent and duration of the resulting interference with the other's right of control;
>
> (e) the harm done to the chattel;
>
> (f) the inconvenience and expense caused to the other.[50]

The Restatement factors focus on the nature and extent of "the dominion or control" that the defendant exercises over the property; that is, what the defendant does with the property. While those factors can apply to the surety's retention of collateral after satisfaction of the bonded obligation, they are not at the crux of the issue presented in the reported cases. Those cases turn on the surety's right to retain the collateral at all. The underlying assumption is that if the surety is not entitled to do so, then the retention, however brief and well-intentioned, constitutes conversion. The courts find themselves grappling much more with contract law (what did the parties' agreement provide) than with conversion law (how extensive was the dominion exercised by the surety over the collateral). The focus on underlying rights is apparently not unusual in conversion cases. As one commentator said:

> [The] issue is resolved by rules about the rights or property interests of [the contesting parties]; tort law is merely the vehicle for enforcing those underlying property rights. So[,] many conversion cases turn primarily on the law of personal property ownership, or on the law of secured transactions, warehouse receipts, or other

[48] *Id.*

[49] RESTATEMENT (SECOND) OF TORTS § 222A(1) (1965).

[50] RESTATEMENT (SECOND) OF TORTS § 222A (1965).

rules under the Uniform Commercial Code, where the rules attempt to delineate the interests held by adverse parties rather than to prescribe conduct.[51]

That this distinction seems not to be well understood by the courts may explain the confusion in the opinions dealing with the retention of collateral by the surety, and there is much of it.[52]

Whether the surety converted the collateral is only half of the problem and probably the less important half. The other half: Assuming that the surety did convert, what are the damages to which the principal is entitled. On that issue, the opinions are neither clear nor consistent and seem to founder on the confluence of contract and tort law. Consider that typically the surety returns the collateral at some point; it does not retain the collateral as its own property. Charging the surety with the value of the collateral — that is, forcing the surety to "purchase" the collateral — which is the traditional remedy for conversion[53] cannot be fair in that situation.[54] The principal has, however, been deprived of the collateral during the time that it was wrongfully retained; should the principal therefore be entitled to compensation for that deprivation? In the case of cash or assets which can readily be liquidated assets, should that value be measured by the interest that would have been earned during the period of wrongful retainer or should the principal be awarded consequential damages based on business opportunities lost because the collateral was unavailable? What about punitive damages? Under traditional contract principles, punitive damages are not recoverable for a breach. But conversion is a tort and torts generally support an award of punitive damages in egregious circumstances. Those issues were considered in the following two cases which came to seemingly inconsistent conclusions.

The following two cases consider such questions and also address the propriety of the surety's retention of collateral in the face of the principal's contention that the bonded obligation has been satisfied.

Pittston Warehouse Corp. v. American Motorists Insurance Co.

One of those cases resulted in four reported opinions, two of which bear on the conversion issues which might confront the surety. In the first, *Pittston Warehouse Corp. v. American Motorists Insurance Co.*,[55] a confusing and disjointed opinion, the court considered

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[51] DOBBS, *supra* note 45, § 61 at 127-28.

[52] An exception is the dissenting opinion in *Nora v. Safeco Insurance Co.*, 577 P.2d 347, 351-56 (Idaho 1978) (McFadden, J., dissenting), which recognizes that the dispute over collateral poses a contract issue and that therefore the successful plaintiff should be limited to contract damages rather than tort damages.

[53] *See* RESTATEMENT (SECOND) OF TORTS § 222A(1) (Conversion occurs when the actor's exercise of dominion over the property so seriously interferes with the other's rights to it that "the actor may justly be required to pay the other the full value of the chattel.").

[54] One cute way to harmonize that situation with the traditional rule is to say that the surety is chargeable with the value of the collateral at the time of conversion but also credited with the value of it at the time it is returned. *See Nora*, 577 P.2d at 352.

[55] 715 F. Supp. 1221 (S.D.N.Y. 1989).

the surety's liability for retaining collateral after U.S. Custom Service warehouse bonds had been terminated. The surety had issued a series of three successive bonds on behalf of the principal, an operator of a bonded warehouse facility, in accordance with federal statutes.[56] The first bond was terminated and replaced by the second bond which thereafter was terminated and replaced by the third bond. The third bond was later terminated and replaced by a bond issued by another surety. With the issuance of each bond, the surety required collateral in an amount equal to the penal sum of that bond but did not release the collateral posted for the prior bond so that with the issuance the surety held collateral of $200,000, the total of the penal sums of the three bonds. The collateral provided for the third bond consisted of a letter of credit for $100,000. As each bond was terminated, the principal requested the return of the corresponding collateral which the surety refused because although the bond was cancelled, the surety remained liable for breaches of the bonded obligation which occurred while the bond was in force. Eventually, the surety released the $100,000 deposited as collateral for the first two bonds, but retained the letter of credit because "upon examination of [the principal's] Balance Sheet, [the surety] determined that the company was not sufficiently financially stable to release the entire collateral …. [and that the surety] would not release the collateral until [the principal] provided [the surety] with a general release from Customs."[57]

Thereupon, the principal sued the surety, and the surety moved for summary judgment which resulted in the first *Pittston Warehouse* opinion.[58] The court first addressed the principal's claim that the surety had converted the collateral. It held that under New York law, conversion required that the plaintiff "show legal ownership of, or a superior possessory right in[,] the disputed property, and that to the exclusion of the plaintiff's rights, the defendant exercised exclusive dominion and control over that property."[59] As to the first element, the surety invoked the indemnity agreement signed by the principal which provided that the surety "has the right to retain collateral until [the surety is] guaranteed to [its] satisfaction that there is no possibility of liability under the bond."[60] In response, the court stated:

> The indemnity agreement is enforceable because it contains valid terms. Under both New York law and statutory law, a satisfaction clause is not fatal to a contract as long as the party requesting satisfaction acts in good faith. Thus [the principal] is obligated to meet [the surety's] demands as long as [the surety] exercises such demands in good faith.[61]

[56] 19 U.S.C.A. § 1555 (West 1999 & Supp. 2009). *See* Maria Charles McGuinness, *Ch. 20, in* THE LAW OF MISCELLANEOUS AND COMMERCIAL SURETY BONDS 263, 278-81 (Todd C. Kazlow & Bruce C. King eds., Am. Bar Ass'n 2001) (discussing the surety's liability under U.S. Customs warehouse bonds).

[57] *Pittston Warehouse*, 715 F. Supp. at 1224.

[58] 715 F. Supp. 1221.

[59] *Id.* at 1225.

[60] *Id.* (apparently paraphrasing, not quoting, the indemnity agreement).

[61] *Id.*

The principal relied on three letters from the Customs Service to the surety which addressed the surety's liability on terminated bonds to establish that it had a superior possessory right to the collateral. The first letter stated that the time of a breach of the bond was generally presumed to be the time that the irregularities were discovered which would mean that a claim would not be made on a bond that had been terminated before such a discovery. That general presumption notwithstanding, the letter also said that the Customs Service could pursue a claim against a terminated bond for breaches that occurred during the period that it was in effect until the expiration of the six-year statute of limitations.[62] The court held that the first letter was ambiguous and did not "adequately relieve [the surety] of liability …. [as] Customs specifically declined to waive its right to assert claims [against terminated bonds]."[63] The principal argued that under the first letter, it was unlikely that a claim would be brought under the terminated bonds. The court rejected that proposition: the principal "cannot establish [the surety's] lack of liability merely by showing that there was no likelihood of a claim; instead [the principal] must show that there is no future liability."[64] Thus, the court held that the surety was entitled to retain collateral until the principal demonstrated that the surety was no longer at any risk. The second and third letters, however, did meet that requirement. The second letter stated that the Customs Service had researched its records and found no claims were outstanding or contemplated, and the third stated that any future claims would be asserted against the bond issued by the other surety which replaced the third bond.[65] Therefore, the principal had shown that as of the surety's receipt of the third letter, the principal had a superior possessory interest in the collateral. The surety's refusal to return the collateral at that time constituted conversion.[66] On that basis, the court awarded partial summary judgment to the principal *sua sponte*.[67]

In addition to its conversion claim, the principal asserted a claim for punitive damages on an allegation that the surety acted in bad faith dealing by holding the collateral. Finding that "these parties' dealings arise are [sic] [from] contracts,"[68] the court interpreted the claim as a

[62] *Id.* at 1223-24.

[63] *Id.* at 1227.

[64] *Id.* at 1226.

[65] *Id.* at1224. There was a short gap between the date of the second letter and that that of the third and the surety claimed that it could still be held liable for claims that arose during that gap. The court disagreed because if there were such claims the surety would have received the statutorily required notification and none had been received. *Id.* at 1226.

[66] The surety tried to argue that the second element of the cause of action for conversion was not present because its retention of the letter of credit did not preclude the principal's use of its rights under the letter of credit and that therefore the surety had not exercised exclusive dominion over the letter of credit. The court rejected the argument, holding that the principal had proven its right to immediate access to the letter of credit and its ancillary rights in that instrument notwithstanding, the surety's retention of it precluded the principal's access even if only partially and temporarily which sufficient to prove the second element of conversion. *Id.*

[67] Because partial summary judgment was awarded to the principal *sua sponte*, the court allowed the surety an opportunity to submit further evidence. The surety did so and requested reconsideration of the court's ruling. Finding that the additional evidence insufficient, the court denied reconsideration in another opinion. Pittston Warehouse Corp. v. Am. Motorists Ins. Co., 739 F. Supp. 904 (S.D.N.Y. 1990).

[68] *Pittston Warehouse*, 715 F. Supp. at 1227.

claim for a bad faith breach of contract.[69] The court awarded partial summary judgment to the surety on this claim because “New York does not recognize a tort of bad faith breach of contract except in the insurance context.”[70] Moreover, even in that context, punitive damages for bad faith claims handling are awarded only “where there is a showing of such morally culpable conduct and wanton dishonesty as to imply a criminal indifference to civil obligations.”[71] The court held that even if the suretyship relationship between the surety and the principal is analogous to insurance, “the facts alleged here are not sufficient to constitute bad faith dealings.”[72]

After the parties submitted their joint pretrial order, the surety moved for summary judgment to dismiss the principal’s damage claims as set forth in the order. That motion resulted in *Pittston Warehouse Corp. v. American Motorists Insurance Co.*,[73] the second opinion in this case which is of significance to the surety. The key intervening fact is that after the court’s *sua sponte* award of partial summary judgment to the principal in the first opinion, the surety consented to the cancellation of the $100,000 letter of credit. The principal’s first damage claim was for interest on the value of the letter of credit for the period that it was wrongfully retained. The court denied the claim because during the period of conversion, the collateral securing the letter of credit was held in a certificate of deposit earning interest which was received by the principal. New York cases awarded interest on converted property in order to indemnify the plaintiff.[74] Permitting the principal to recover interest a second time from the surety was not allowable as it would “far exceed the goal of indemnification.”[75]

The principal also asserted a claim for consequential damages, including lost profits, in connection with the purchase of another warehouse operation which dissolved when the surety refused to return the collateral. The court ruled that the principal was not entitled to consequential damages because it had already been compensated for the deprivation of its property during the conversion by its receipt of interest.[76] It is not clear from the opinion whether the court would have allowed consequential damages claim if the principal had not received the interest or whether interest was prescribed remedy such that the principal would not have been able to choose between interest and consequential damages.

Next, the principal claimed punitive damages based upon the allegation that the surety’s refusal to return the collateral constituted bad faith conversion of it. That claim is to be distinguished from its claim for punitive damages in the earlier proceeding which the principal

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[69] *Id.*

[70] *Id.* (internal quotation marks and citations omitted).

[71] *Id.* at 1228 (internal quotation marks and citations omitted).

[72] *Id.*

[73] 1991 WL 95035, at *1 (S.D.N.Y. May 23, 1991), *aff’d*, 954 F.2d 62 (2d Cir. 1992).

[74] *Id.* at *3 (citing cases).

[75] *Id.*

[76] *Id.* at *4.

based on the allegation that the surety's retention of the collateral constituted a bad faith breach of contract. New York law permitted punitive damages for conversion "where circumstances establish that the conversion was accomplished by malice or reckless or willful disregard of the plaintiff's right."[77] Equating the New York standard for bad faith conversion with the standard for bad faith breach of contract in the insurance claims handling context, the court rejected the claim as a matter of law because the principal had not adduced any evidence other than that upon which it relied in the earlier proceeding.[78]

What is the net result of the two *Pittston Warehouse* decisions? The principal was able to persuade the court that the surety's retention of collateral after the possibility of bond liability ceased constituted conversion. That success, however, appears to have been a hollow victory because at least with respect to the letter of credit, the principal was unable to recover any damages.[79] It does seem to be clear that under New York law at least, interest on the value of the collateral is an appropriate, though not necessarily exclusive, remedy for a temporary and partial deprivation of the collateral. When the principal has received interest, it may not also recover consequential damages. Punitive damages for bad faith — whether based on the tort of conversion or a breach of contract in the insurance context — are not available without meeting a relatively high standard which requires a showing of malice, moral culpability, wanton dishonesty, and a willful, near criminal disregard of the principal's rights to the collateral. As to liability, the importance of the case is that the court insisted on an unambiguous showing that the surety did not face any future liability in order to conclude that the principal had a superior possessory interest in the collateral; the equivocal evidence as to the surety's future risk was not enough, even it liability was shown to be unlikely.

Luzar v. Western Surety Co.

In *Luzar v. Western Surety Co.*,[80] the surety issued on behalf of the principal, a trucking partnership, statutorily required "track buyers bonds" which secured the principal's obligations in connection with the buying, transporting and selling of hay.[81] The surety required, and the principal deposited, a $11,500 certificate of deposit as collateral to secure the surety's obligations under the track buyers bonds. The collateral was delivered pursuant to a security agreement between the surety and the principal which provided that "'the Surety shall have the

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[77] *Id.* at *5 (internal quotation marks and citations omitted).

[78] *Id.* The court also rejected the principal's claim for attorney's fees because the principal's punitive damages claim was invalid and because the letter of credit contained no provision authorizing an award of attorney's fees to the principal, such a contractual authorization being the only basis upon which attorney's fees could be allowed.

[79] The second *Pittston Warehouse* opinion, 1991 WL 95035 at *1, which dismissed the damage claims did so in relation to the retention of the $100,000 letter of credit. The first *Pittston Warehouse* opinion, 715 F. Supp. 1221, stated that the surety committed conversion by refusing to return the $100,000 in cash deposited for the first two bonds but then ruled that the principal was not entitled to interest in connection with the conversion of that collateral because it had been properly withheld under the indemnity agreement. The latter conclusion seems inconsistent with finding that the surety converted that collateral, neither opinion gives a hint as to whether the principal was entitled to a damage claim other than interest as a result of that conversion.

[80] 692 P.2d 337 (Idaho 1984).

[81] *Id.* at 338.

right in its discretion to retain said collateral until the liability of the Surety on account of having executed said bond … shall cease and determine'" and that "'[i]n case of the termination of the liability of the Surety without loss or damage or expense … and competent evidence is furnished by the Depositor to [that] effect, the said collateral shall be returned thereupon to the Depositor ….'"[82] Eventually, the principal obtained substitute bonds from a different surety which did not require collateral and the first surety's bond was cancelled. Thereupon, the principal requested the return of the collateral from the first surety, which refused. With a second request, the principal offered in writing to prove, through their affidavits, that all of the "growers-customers" with which it had done business during the period of the bond had been paid in full and to demonstrate, through its books and records, that no claims had been asserted against it. Again, the surety refused to return the collateral, and advising the principal that the surety's policy was to retain collateral for six months following the termination of bonds.[83] Before the six months expired, the principal sued the surety for conversion. In defense, the surety argued that the security agreement gave it the right to retain the collateral after the cancellation of the bond "until the four or five year statute of limitation has run."[84] The case was tried to a jury which found in favor of the principal, awarding to it $11,500, the value of the collateral, $65,000 for "general damages" (lost profits caused by undercapitalization resulting from the surety's refusal to return the collateral), $11,500 in punitive damages, and attorney's fees.

On appeal, the Idaho Supreme Court, one justice dissenting, affirmed the judgment. Invoking earlier decisions, the majority defined conversion as "a distinct act of dominion wrongfully asserted over another's personal property in denial [of] or inconsistent with [the] rights therein" and found that "[a] cause of action for conversion is a remedy available to a pledgor against a secured party-pledgee who refuses to return the collateral if a security agreement does not give a legal right to retain collateral after a demand for return by the pledgor."[85]

The surety argued that the trial court's instructions improperly permitted the jury to decide the case on the basis of the reasonableness of the surety's retention of the collateral when the only issue should have been whether retention of the collateral was authorized by the terms of the security agreement. In rejecting that argument, the court said that reasonableness was properly at issue because "pertains, among other things, to the good faith of the pledgee in dealing with the collateral" after a demand for its return and good faith and fair dealing are implied in all contracts.[86] The court also acknowledged that if the secured party had a contractual right to retain the collateral, its refusal to return it would not constitute an "act of dominion wrongfully asserted" and stated that "[w]hether conversion exists in the present case depends on the interpretation and legal effect of the security agreement."[87] The

[82] *Id.* at 339 (quoting security agreement).

[83] *Id.*

[84] *Id.*

[85] *Id.* at 340 (internal quotation marks and citations omitted).

[86] *Id.*

[87] *Id.*

court ruled that fact that the agreement gave the surety the right to retain the collateral until bond liability "shall cease and determine" did not authorize the surety to hold the collateral until the expiration of the statute of limitations. The surety's liability would end by either the expiration of the statute or the fulfillment by the principal of the bonded obligation. Thus, under the security agreement, the issue was whether the principal had tendered to the surety "competent evidence" that the bonded obligations had been satisfied. The court held that that question was properly left to the jury because the phrase "competent evidence" was ambiguous as a matter of law.[88]

As to the damages, the court held that the testimony of the principal, several farmers, and a competitor was sufficient evidence that the principal lost profits because the collateral was not available to it. The court also ruled that there was evidence sufficient to support punitive damages. It cited, among other things, the facts that the partners of the principal "were honest, hardworking businessmen with an excellent credit reputation" and that the surety rejected the principal's tendered evidence on the basis because its policy was to wait for six months after cancellation of the bond and then took another position at trial that it had complete discretion under the security agreement to hold the collateral until the statute of limitations had run. "From such a set of facts," the court said, "a jury could reasonably infer that [the surety's] actions were in bad faith and outrageous."[89]

Did the *Luzar* court judge the surety's refusal to return collateral more harshly than the *Pittston Warehouse* court? The latter court found that retention was justified by when the principal's evidence was equivocal as to the surety's liability, while the former allowed a jury to evaluate the reasonableness of the surety's response to the principal's tender even under an agreement which seemed to give the surety discretion in making that response. The conduct of the surety in *Luzar*, however, was clearly more high-handed. These may not be significant distinctions. On the other hand, the differences between the two cases as to the measure of damages for conversion are striking. Under *Pittston Warehouse*, the principal's damages might well be limited to interest for the period of the conversion, while under *Luzar* the principal can recover *both* the value of the converted collateral *and* consequential damages resulting from its deprivation. Moreover, at least the language used in *Pittston Warehouse* suggests that substantially higher standard applies to the availability of punitive damages than that employed in *Luzar*.

III. POTENTIAL STRATEGIES FOR AVOIDING THE DILEMMA

There are two components to the surety's dilemma: one, the revival of the surety's liability when the obligee is compelled to disgorge a preferential payment which the principal made to satisfy a bonded obligation; and two, the risk of the surety's being held liable for conversion if the surety, fearing such a revival, refuses the demand for the return of the collateral which made the principal makes after satisfying the bonded obligation. If either component can be negated, the dilemma will disappear. Thus, if the surety has a right to the

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[88] The dissent's primary criticism was that the majority's acceptance of the instructions allowing the jury to decide the case on the reasonableness of the surety's retention of the collateral was inconsistent with it statement that whether conversion existed depended on the interpretation and legal effect of the security agreement. *Id.* at 343-44.

[89] *Id.* at 343.

collateral which is superior to that of the principal when the demand is made, a refusal to return the collateral cannot constitute conversion. There are provisions that could be included in an agreement with the principal as to the collateral which might give the surety a superior right and they are considered in section A of this Part. Alternatively, the surety may be able to contest the trustee's attempt to recover a claimed preferential payment and thereby prevent the revival of liability altogether. Section B of this Part considers the procedures and substantive grounds by which the surety can oppose a preference action.

A. *Negating Conversion Through Terms of an Agreement as to Collateral*

Both *Luzar* and *Pittston Warehouse* held that the terms of a written agreement on collateral govern the surety's right to retain collateral.[90] Subject to the obligation to exercise its rights reasonably and in good faith, if the surety is entitled under the terms of an agreement with the principal to hold the collateral, the surety has a superior possessory right in the collateral and its refusal to return does not constitute conversion. Indeed, the court in *Pittston Warehouse* appears to have enforced the terms of the indemnity agreement, which it described as permitting the surety to retain collateral until the surety was satisfied that there was no possibility of bond liability,[91] by holding that an equivocal letter from the Customs Service did not require the surety to release the collateral.[92] Thus, the surety will want to consider including in the indemnity agreement, or separate collateral or security agreement, provisions which give the surety superior possessory rights in the collateral. There are several possibilities which are considered in the sections which follow.

The principal's consent to the requirements and conditions of such provisions should be obtained either before, or at the time when, the collateral is deposited. Attempting to impose them on an *ad hoc*, after the fact basis when the principal demands the return of the collateral will invite liability. In *Luzar*, for example, the surety invoked its "policy" of waiting six months after termination of the bond when the principal demanded the collateral. The policy was not included in the security agreement which specifically addressed the return of collateral, and it does not otherwise appear that prior notice of the policy had been given to the principal. As a result, the court cited the surety's invocation of that policy, together with its reliance on an entirely different justification at trial, as one of the pieces of evidence from which the jury could infer that the surety acted in bad faith.[93] If, however, the requirement of a release from the obligee is presented to, and accepted by, the principal when the collateral is deposited, it may well be enforceable as part of the agreement between them which the courts have indicated that they accept as governing the respective rights of the parties.

[90] Luzar v. Western Surety Co., 692 P.2d 337, 340 (Idaho 1984); Pittston Warehouse Corp. v. Am. Motorists Ins. Co., 715 F. Supp. 1221, 1225 (S.D.N.Y. 1989).

[91] *Pittston Warehouse*, 715 F. Supp. at 1225.

[92] *Id.* at 1227.

[93] *Id.* at 343.

1. The Surety's Right To Hold Collateral Until All Risk of Liability Has Ended

At a minimum, the surety should insist on a provision which gives it the right to retain collateral until all risk of liability[94] by reason of having issued bonds on behalf of the principal ceases. Still, such a provision will not enable the surety to avoid liability for conversion simply because it does not wish to release the collateral. Courts will require that the surety exercise its contract rights reasonably and in good faith which means that some possibility of liability must be shown to exist. However, making explicit the surety's right to retain collateral when a risk does exist is risk will position the issue to the surety's best advantage in the event of litigation.

2. The Surety's Right To Require that the Principal Provide a Release from the Obligee

The surety should also consider a provision which requires that the principal provide a full release from all obligees as a condition of the surety's return of the collateral. Such a condition would give definition to the surety's right to retain the collateral until the risk of liability is terminated by establishing an objective criterion for determining whether or not that risk has, in fact, been extinguished. To that extent, this provision should reduce the danger of a court's undervaluing the risk of liability after the fact.

Although the release requirement would negate conversion by giving the surety a superior possessory right if it is not complied with, it will not prevent the revival of the surety's liability to the obligee which is forced to disgorge a payment as a preference. The obligee's right to obtain satisfaction from the surety when it has had to surrender a preferential payment to the trustee will trump a release that the obligee may have given in exchange for that payment.[95]

3. The Surety's Right To Retain Collateral Until 91 Days After the Last Payment in Satisfaction of Bonded Obligations

The surety has continuing potential liability to bond obligees and other beneficiaries for payments that are returned as avoidable preferences pursuant to § 547(b) of the Bankruptcy Code.[96] Time is a key element of § 547(b): only payments made within 90 days of the principal's bankruptcy petition, or one year if the payment is to an insider,[97] can be recovered.

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[94] The security agreement in *Luzar* gave the surety the right to retain the collateral "until the liability of the Surety … shall cease and determine," *Luzar*, 693 P.2d at 339. The term "liability of the Surety" suggests that the surety would have to show the prospect of some actual liability to retain the collateral. Perhaps the term "risk of liability" might allow the surety to invoke potential liabilities which are more remote.

[95] *See* Centre Ins. Co. v. SNTL Corp. (*In re* SNTL Corp.), 380 B.R. 204, 215 (B.A.P.9th Cir. 2007) (the obligee's "remedies available at law" against the guarantor as a result of disgorgement included revival of the guarantor's obligations, which superseded the release provisions of the principal's contract with the obligee).

[96] State insolvency, liquidation, and receivership statutes also contain avoidable preference sections as well. *See,* discussion *supra* notes 38-39. The principles of this section can, and should, be applied to dealings with principals who are established through state law, such as banks and insurance companies.

[97] Under § 547(b)(4)(B) (West 2004 & Supp. 2009), payments made to "insiders" are subject to avoidance as preferences if made up to one year prior to the bankruptcy filing. An "insider" is elaborately defined in

Therefore, if the principal does not seek bankruptcy protection within 90 days after payments made in satisfaction of the bonded obligation are made, those payments will not be subject to disgorgement under § 547(b), and the surety will not need collateral as security for those obligations. If the principal does file for bankruptcy within the preference period, the surety will be able to withstand the revival of its liability from a § 547(b) disgorgement by including in the indemnity agreement or separate collateral or security agreement a provision giving the surety the right to retain collateral for 91 days after the last payment in satisfaction of the bonded obligation is made; that is, until after the risk of the revival of liability has ended. Thus, if liability has been discharged by a payment which is recovered as a preference, the surety will have collateral with which to satisfy its revived obligation. If liability has been discharged in some other manner — for example, expiration of the statute of limitations — disgorgement and revival of bond liability will not be possible and collateral will not be needed.

Would such a provision be enforceable under the conversion cases? The cases say that agreements pertaining to collateral will be enforced, and therefore a 91-day retention right would start with the legitimacy of having been agreed to by the principal. Of course, courts circumscribe contractual rights with the obligation that they be exercised reasonably and in good faith. Even so, there are grounds upon which the reasonableness of such a provision can be defended. The 91-day retention right has definite ending point and is not open-ended. In addition, 91 days is a relatively short period such that depriving the principal of collateral for that length of time should not be viewed as a substantial interference with its rights in the collateral. The principal, of course, can be expected to contest that assertion. In response, the surety can point out that 91-day retention right is rationally related to at least a possibility of liability which should outweigh the relatively brief interference with the principal's rights, particularly since the principal consented to that right. The principal will likely assert that there is no risk of its falling into insolvency and hence allowing the surety to retain the principal for any length of time is unreasonable. In this connection, the court's holding in *Pittston Warehouse* that the lack of the likelihood of liability is insufficient to require the release of collateral[98] could have some bearing, at least if the 91-day retention right is coupled with the right to retain the collateral until the risk of liability has ended. Even though such a provision could be challenged, the surety will be far better off for having included the provision in an agreement with the principal. If the surety does not contractually reserve the right but seeks to assert it only if it comes to fear, at the time that the return of the collateral is demanded, that the principal is headed to bankruptcy, the surety may be required to prove the reasonable likelihood that the principal is on the brink of insolvency.

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§ 101(31) and includes relatives and partners of debtors who are individuals; directors, officers or person in control of debtors which are corporations; general partner, relatives of general partner, or person in control of debtors which are partnerships; and similar kinds of relationships. Obviously, it will be much more difficult to justify a one-year retention right simply on the basis of the existence of § 547(b)(4)(B). A court would very likely require a showing of at least the potential that satisfaction of the bonded obligation would involve a payment to an insider.

[98] *Pittston Warehouse*, 715 F. Supp. 1226.

4. The Surety's Right To Retain Collateral for Two Years After the Principal's Bankruptcy Filing

Generally, an action to set aside a preferential payment under § 547(b) must be commenced within two years after the filing of the bankruptcy petition.[99] Therefore, the surety should reserve the right to retain the collateral for up to two years after filing if the principal does seek bankruptcy protection. The value of such a provision is limited to those situations in which the principal does not request the release of the collateral until after filing for bankruptcy. It will be of no benefit to the surety if the principal demands release of the collateral before that time. On the other hand, once the principal has filed for bankruptcy, it should be relatively easy to determine whether payments in satisfaction of bonded obligations were made in the preceding 90 days. If such payments were made, the likelihood of preference actions by the trustee under § 547(b) would almost certainly satisfy requirements that the surety exercise its rights reasonably and in good faith.

B. *Negating Revival of Liability by Contesting the Trustee's Preference Action*

In addition to, or in lieu of, negating conversion through provisions in a collateral agreement, the surety may seek to avoid the revival of its liability by acting to prevent disgorgement of a payment made in satisfaction of a bonded obligation in the first place. The surety may be able to do so by contesting the preference action by the trustee to avoid the transfer and recover the payment. The surety's procedural right to oppose the trustee and the substantive grounds for doing so are considered below.

1. The Surety's Right To Intervene in an Adversary Proceeding by the Trustee Against the Transferee

The surety's right to intervene in an adversary proceeding by the trustee against the transferee is governed by the same standards as intervention generally.[100] Federal Rule of Civil Procedure 24 provides in pertinent part:

> **(a) Intervention of Right.** On timely motion, the court must permit anyone to intervene who:
>
> . . .
>
> **(2)** claims an interest relating to the property or transaction that is the subject of the action, and is so situated that disposing of the action may as a practical matter impair or impede the movant's ability to protect its interest, unless existing parties adequately represent that interest.

[99] 11 U.S.C. § 546(a)(1)(A) (West 2004).

[100] Federal Rule of Bankruptcy Procedure 7024 states: "Rule 24 F.R.Civ.P. applies in adversary proceedings." Fed. R. Bankr. Pro. 7024 (West 2009).

As the party ultimately liable for payments that are disgorged in a preference action, the surety appears to come within the express terms of the rule. Neither of the other parties have any reason to protect the surety's interest. The trustee is the party seeking the return of the payment and will advance a position which would result in the revival of the surety's liability. The obligee will oppose the assertion of a preference which would benefit the surety. However, the obligee will be looking to pass on an adverse judgment to the surety and therefore, in the final analysis, has an interest adverse to that of the surety. In such circumstances, the surety should be allowed to intervene.[101]

2. Grounds for Contesting the Trustee's Complaint Against the Transferee.

The trustee has the burden of proving that the payment satisfies the five criteria of § 547(b)[102] and hence may be set aside as a voidable transfer.[103] The courts have ruled, however, that funds held by the principal under the following two circumstances do not constitute property of the estate and hence the principal's transfer of those funds does not constitute a preference: funds which the principal holds in trust and funds which the principal holds subject to direction as to their disposition. In addition, § 547(c) designates certain types of transfers which may not be set aside as preferential transfers. Among them are transfers which were contemporaneously exchanged for new value and transfers which were made in the ordinary course of business. The party opposing the claim of preference has the burden of proving that a transfer is not a voidable preference under § 547(c).[104] The following sections consider those four grounds for opposing the trustee in turn.

a. *Contract Payments Which Constitute Trust Funds Under State Statutes or the Terms of an Indemnity Agreement May Not Be the Property of the Debtor's Estate.*

Under § 547(b), "[a] preference does not take place unless the transaction involves a 'transfer of an interest of the debtor in property.'"[105] Property of the bankruptcy estate is

[101] *See, e.g.*, Price v. Carlton, 48 S.E. 721, 723 (Ga. 1904) (surety granted leave to intervene in interests of equity where principal was bankrupt and no longer fully protected surety's interests).

[102] The five elements of 11 U.S.C.A. § 546(b) (West 2004 & Supp. 2009) are set out *supra* text accompanying note 15.

[103] *See* 11 U.S.C. § 547(g) (West 2004) ("For the purposes of this section, the trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section and the creditor or party in interest against whom recovery or avoidance is sough has the burden of proving the nonavoidability of a transfer under subsection (c) of this section."); Precision Walls, Inc. v. Crampton, 196 B.R. 299, 302 (E.D.N.C. 1996) ("the trustee bears the burden of proving the avoidablility of a transfer under subsection (b) of § 547, but the transferee bears the burden of proving the nonavoidability of a transfer under the affirmative defenses contained in subsection (c).").

[104] 11 U.S.C.A. § 547(g).

[105] Miller v. Perini Corp. (*In re* A.J. Lane & Co.), 164 B.R. 409, 418 (Bankr. D. Mass. 1994) (quoting 11 U.S.C. § 547(b)).

generally broadly defined,[106] however, it does not include property which the debtor holds as a trustee:

> **(d)** Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.[107]

Therefore, when the principal-contractor pays a subcontractor, for example, out of funds which the principal holds in trust for the benefit of such a payee, the payment cannot be recovered as a preference by the principal's bankruptcy trustee because the funds paid were not property of the principal.[108] Funds in the hands of the principal can be impressed with such a trust under state construction trust fund statutes or under the trust provision of the indemnity agreement or both[109]

For instance, in *Building Dynamics, Inc. v. Grisofe Electric Corp.*,[110] the Chapter 7 trustee of the debtor, a general contractor, sought to set aside a prepetition payment from the debtor to a subcontractor for work done on a construction project in New York.[111] The court held that the payment could not be set aside because the funds were never "property of the debtor"[112] as required by § 547(b). The court reasoned:

> If a transfer consists of trust funds, then the payment was not a property of the debtor. Therefore, the question is whether trust funds arose under state law.

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[106] *See* 11 U.S.C. § 541(a) (West 2004).

[107] 11 U.S.C. § 541(d) (West 2004).

[108] *See* Universal Bonding Ins. Co. v. Gittens & Sprinkle Enters., Inc., 960 F.2d 366, 373 (3d Cir. 1992); MPC Cash-Way Lumber Co. v. Collins (In re Collins), 266 B.R. 123, 127 (Bankr. N.D. Ohio 2000); In re Alcon Demo., Inc., 204 B.R. 440, 448-49 (Bankr. D.N.J. 1997); Amwest Sur. Ins. Co. v. U.S. Nat'l Bank of Or. (*In re* Comcraft, Inc.), 206 B.R. 551, 555 (Bankr. D. Or. 1997); Cooper v. Grisofe Elec. Corp. (*In re* Building Dynamics, Inc.), 134 B.R. 715, 716-17 (Bankr. W.D.N.Y. 1992); Architectural Building Components v. McClarty (*In re* Foremost Mfg. Co.), 137 F.3d 919, 923 (6th Cir. 1998); City Nat'l Bank of Miami v. Gen. Coffee Corp. (*In re* Gen. Coffee Corp.), 828 F.2d 699, 701-03 (11th Cir. 1987).

[109] Under some state construction trust fund statutes, contract funds in the hands of the owner may also be subject to a trust in favor of the principal's project creditors. *See, e.g.*, N.Y. Lien Law § § 70-79a (West 2009).

[110] 134 B.R. 715 (Bankr. W.D.N.Y. 1992).

[111] *Id.* at 716.

[112] *Id.*

> New York Lien law creates a trust and requires that funds received by a general contractor for the improvement of real property be held in trust for the benefit of subcontractors....[113]

Although the debtor had deposited the funds paid by the owner into the debtor's general account and the payment to the subcontractor was made from that account, the debtor nevertheless asserted that it paid the subcontractor with funds that originated with the owner as required by the New York Lien Law. Such comingling can be a substantial problem in trying to establish that payments were made out of trust funds as opposed to funds from another source. In this case, however, the court held that the comingling did not destroy the trust character of the funds paid by the debtor to the subcontractor. Although not specifically mentioned by the court, the burden of proof imposed on the trustee by § 547(g) may have come into play:

> The trustee has not proved any facts to indicate that the amount paid to [the subcontractor] is not traceable to the amount received from [the owner] or is not part of the trust funds. The stipulated facts indicate that the amount paid to [the subcontractor] was part of the $68,183.00 received by [the debtor] from [the owner]. Therefore, the $2,912.00 transfer to [the subcontractor] is not a preference under 11 U.S.C. § 547(b) since it was not property of the debtor....[114]

In *In re Alcon Demolition, Inc.*,[115] the surety successfully invoked the trust provision of the general indemnity agreement to prevail over the claim of its principal, a Chapter 11 debtor, to the proceeds of an arbitration award in favor of the principal and against the owner of the project bonded by the surety. The provision recited that all funds due or to become due under bonded contracts were trust funds which the principal was obligated to hold for the benefit of the surety for any bond liability or loss. Pursuant to its payment bond, the surety had paid substantial sums to subcontractors and materialmen who furnished labor and material to the bonded project. Therefore, the surety asserted, the trust fund provision created an express trust under New Jersey law pursuant to which the arbitration award to the principal should be paid to the surety to the extent of its loss.[116] The court agreed that all the elements for an enforceable trust were established: intent to create a trust; a trust *res*; an identifiable beneficiary; and a trustee.[117] Therefore, the court held that the arbitration award, up to the

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[113] *Id.* (citing N.Y. Lien Law § § 70-79a).

[114] *Id*. at 718. *Cf. Collins*, 266 B.R. at 126-27 (contractor's debt to subcontractor was nondischargeable, since contractor owed subcontractors, workers, and materialmen a duty to hold funds in trust for their benefit under Michigan law).

[115] 204 B.R. 440 (Bankr. D.N.J. 1997).

[116] *Id.* at 448-49.

[117] The court quoted the trust fund provision as follows: "It is expressly understood and declared that all monies due or to become due under any contract or contracts covered by the Bonds are trust funds, whether in the possession of [Debtor] or otherwise for the benefit of and for payment of all such obligations in connection with any such contract or contracts for with [the surety] would be liable under any of said Bonds, for which said trust inures to the benefit of [the surety] for any liability of loss it may have to sustain under any said Bonds, and this Agreement and Declaration shall also constitute notice of such trust." *Id.* at 448-49.

amount of the surety's loss, was impressed with a trust for the benefit of the surety and did not constitute property of the debtor's estate.[118]

When confronted by a preference action, the surety should consider whether it can argue that under applicable state statute or the indemnity agreement, the claimed preferential payment was of funds which the debtor held in trust. If so, those funds were not property of the debtor and therefore may not be recovered as a preference under § 547(b).

b. The Earmarking Doctrine.

The debtor may lack control over the disposition of funds in its possession for reasons other than the imposition of trust obligations. The debtor may receive funds from a third party which are accompanied by a direction of the third party that the funds be used only to pay a specified creditor. Courts have held that funds which are subject to such a direction may not constitute property of the debtor's estate for § 547(b) purposes.[119] Such rulings are an application of the "earmarking' doctrine"[120] which applies when

> the debtor had so little control over disposition of the funds that the payment [by the debtor to the creditor] should be treated as though made by the third party directly to the creditor. If the debtor had no control over the funds, no true transfer is considered to have taken place, only a substitution of creditors. [121]

When the debtor has no control over the disposition of the funds, the debtor is in no worse a position after transferring such funds than it was before doing so[122] and therefore the

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[118] *Id.* at 449.

[119] *See, e.g.*, Gold v. Alban Tractor Co., 202 B.R. 424, 426-27 ("payments made by a [third party] to a supplier who was a creditor of a debtor ... are generally not considered part of the debtor's bankruptcy estate if the [third party] has an independent obligation to pay the supplier.") (*citing In re* Flooring Concepts, Inc., 37 B.R. 957, 961 (9th Cir. BAP 1984), Keenan Pipe & Supply Co. v. Shields, 241 F.2d 486, 489-90 (9th Cir. 1956)); Coral Petro., Inc. v. Banque Paribas-London, 797 F.2d 1351, 1359-60 (5th Cir. 1986) (repayment of loan to unsecured creditor within 90 days of bankruptcy was not preferential payment where debtor lacked dispositive control of the funds, even though funds were placed in debtor's general account, when funds were earmarked by third party for the benefit of the creditor); Herzog v. Sunarhauserman (*In re* Network 90 Degrees, Inc.), 98 B.R. 821, 832-34 (Bankr. N.D. Ill. 1989) (debtor did not have sufficient control over joint checks for trustee to establish that they were property of the debtor's estate).

[120] Miller v. Perini Corp. (*In re* A.J. Lane & Co.), 164 B.R. 409, 418 (Bankr. D. Mass. 1994).

[121] *Id.* The court said that "[t]he earmarking doctrine is an extension of the *Nat'l Bank of Newport* decision," *id.*, applying National Bank of Newport v. National Herkimer County Bank, 225 U.S. 178 (1912) which held under § 60 of the Bankruptcy Act of 1898 that a transfer of the debtor's property did not occur when a third party paid a creditor of the debtor directly.

[122] *See* Stingley v. AlliedSignal, Inc. (*In re* Libby Int'l), 247 B.R. 463, 467 (8th Cir. BAP 2000) ("The ultimate analytical result ... is that earmarking situations are analyzed in terms of the net result of the transaction, *i.e.*, whether there is a diminution of the debtor's estate."). In a similar vein, § 547(b)(5) requires that the payment has the result of preferring one creditor over the others. Where the surety, or other guarantor, has an independent obligation to pay bond beneficiaries, and does so out of funds that would have otherwise gone to the general contractor, the funds are not part of the estate and the surety has simply substituted itself in as creditor of the debtor. *See* Cunningham v. T & R Demolition, Inc. (*In re* ML & Assocs.), 301 B.R. 195, 202 (N.D. Tex. 2003).

funds were not part of the bankrupt's estate for preferential transfer purposes.[123] For example in *Herzog v. Sunarhauserman*,[124] the debtor sold furniture, textiles and movable walls for office interiors which it purchased from the creditor. Those parties entered into an agreement under which the debtor directed its customers to pay the debtor's invoices by checks drawn jointly to the debtor and the creditor; the joint checks were sent to the creditor; the debtor granted the creditor a power of attorney to endorse and negotiate the joint checks; and the creditor applied the proceeds of the joint checks to the amounts owed by the debtor for products purchased from the creditor.[125] The court said that "whether … a transfer amounts to a preference largely depends on whether the debtor had control over the property that was transferred, and also whether the transfer depleted the estate."[126] The court concluded that the payments made by customers directly to the creditor by joint checks were not preferential transfers of the debtor's property under § 547(b) because under the joint check agreement and the mechanics of enforcing it, the debtor did not have control of the payments made by its customers.[127] The agreement gave the creditor the right to receive the payments and apply the proceeds to the debtor's account which negated the debtor's right to obtain and use the payments for its own purposes. The agreement was enforced by the use of joint checks sent directly to the creditor which deprived the debtor of possession of the physical instruments by which the customers made payment.

Joint check arrangements are common in the construction industry. Therefore, the surety should be alert to opportunities to use the earmarking doctrine. It would apply, for example, when the trustee seeks to recover payments which the principal made to a subcontractor pursuant to a joint check agreement with the subcontractor and the owner.

c. Contemporaneous Exchange for New Value

Section 547(c) provides:

> **(c)** The trustee may not avoid under this section a transfer —
>
> **(1)** to the extent that such transfer was —
>
> **(A)** intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

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[123] *Id.*

[124] 98 B.R. 821 (Bankr. N.D. Ill. 1989).

[125] *Id.* at 823.

[126] *Id.* at 835 (reviewing cases and various formulations of the applicable standard).

[127] 98 B.R. at 832.

(B) in fact a substantially contemporaneous exchange.[128]

Section 547(a) also provides:

> **(2)** "new value" means money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation;[129]

Sureties have successfully invoked the "new value" exception of § 547(c)(1) to defeat claims that the principal's payments to subcontractors constituted preferential transfers and as a result avoided the revival of their liability.[130] In *O'Rourke v. Seaboard Surety Co.,*[131] for example, the general contractor on a Miller Act project made a payment to two of its subcontractors within 90 days before filing a Chapter 7 bankruptcy petition.[132] The trustee commenced an adversary proceeding against the subcontractors to recover the payments as preferences under § 547(b). The subcontractors brought in the contractor's surety as a third party defendant, seeking indemnity from the surety if they were required to disgorge the payments to the trustee. Directly attacking the preference claim, the surety argued that if it were called upon to pay the subcontractors under its bond because its principal, the contractor, failed to do so, then under *Pearlman v. Reliance Insurance Co*.,[133] it would then be subrogated to the principal's rights in the contract balance and therefore would have an equitable lien on the contract balance which would otherwise be payable to the principal.[134] By paying the subcontractors, the principal contemporaneously extinguished the surety's equitable lien which resulted in new value to the principal. Agreeing with that analysis, the Ninth Circuit held that the principal's payments were not avoidable preferences under § 547(b) because "payments by a debtor in exchange for a secured creditor's release of its security interest falls within the exception of § 547(c)(1)."[135]

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[128] 11 U.S.C. § 547(c)(1) (West 2004 & Supp. 2009) (internal formatting omitted).

[129] 11 U.S.C. § 547(a)(2) (West 2004).

[130] O'Rourke v. Seaboard Sur. Co. (*In re* E.R. Fegert, Inc.), 887 F.2d 955, 958-59 (9th Cir. 1989); *see also* Lubman v. C.A. Guard Masonry Contractor, Inc. (*In re* GEM Constr. Corp.), 262 B.R. 638, 646 (Bankr. E.D. Va. 2000) (release of lien is new value to the extent that it is secured by estate assets, therefore payments were not avoidable to the extent of surety's release of lien); Newberry Corp. v. Fireman's Fund Ins. Co., 106 B.R. 186, 187-88 (D. Ariz. 1989) (surety's release of equitable lien constitutes "new value").

[131] *O'Rourke*, 887 F.2d 955.

[132] *Id.*

[133] 371 U.S. 132 (1962).

[134] *O'Rourke*, 887 F.2d at 957-58

[135] *Id.* at 959.

Although the fact that the principal's payments reduced the surety's bond liability worked to the surety's advantage in *O'Rourke*, that fact can also backfire on the surety. In *Newberry Corp. v. Fireman's Fund Insurance Company*,[136] the debtor-in-possession under Chapter 11 of Bankruptcy Code brought an adversary proceeding against its surety to recover payments which the debtor made to its suppliers during the preference period. It argued that the payments were preferences to the surety as well as to the suppliers "because they [the payments] reduced the amount [the surety] would have had to pay on its bonds if [the debtor] had defaulted."[137] The court accepted the argument to a point.[138] Because the reduction of the surety's bond liability also "simultaneously reduced dollar for dollar the equitable subrogation lien [the surety] would have obtained had it made the payments itself" the debtor received new value in exchange for the payments and therefore the payments fell with the § 547(c)(1) exception as did the payments in *O'Rourke*. However,

> To the extent [the surety's] preference exceeded the amount of contract proceeds that could have been released from an equitable lien, they would amount to the release of an unsecured indemnity claim against the estate. The release of secured indemnity claims do not constitute 'new value' within the meaning of § 547(a)(2). Because count 13, and its amended counterpart states as much, it presents a valid legal claim and should not have been dismissed [by the bankruptcy court].[139]

While the release of the surety's equitable lien will constitute "new value" which may save the surety from liability for payments made by the debtor-principal to job creditors on the bonded project, the § 547(c)(1) exception may not protect the surety from having to disgorge collateral which is posted by the principal within 90 days before the principal files for bankruptcy. When the surety issues new bonds upon the deposit of collateral in that situation, arguably the surety has given new value in exchange for the collateral.[140] On the other hand, when the surety requires collateral because of a perceived deterioration in the principal's financial condition, it likely has not given new value. The surety's argument would be that by not cancelling existing bonds, it has given a benefit to the principal in return for the collateral. However, courts have also found that simple forbearance by the surety, for example refraining from cancelling bond coverage in exchange for a collateral deposit, would not constitute new value under § 547(c)(1).[141]

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[136] 106 B.R. 186 (D. Ariz. 1989).

[137] *Id.* at 186-87.

[138] *Id.* at 187.

[139] *Id.* at 188 (internal quotation marks and citations omitted).

[140] *See In re* E-Z Serve Convenience Stores, Inc., 377 B.R. 491, 500-01 (Bankr. M.D.N.C. 2007) (denying summary judgment to trustee in avoidable preference action against surety that received collateral from debtor where surety wrote new bonds contemporaneously with receipt of collateral).

[141] *Id.* at 501 (denying summary judgment to surety that received collateral from debtor at time that it wrote new bonds because of evidence that some collateral went to securing previous obligations of the surety on bonds that the surety agreed to keep in force upon receipt of the collateral); *see also In re* ABC-Naco, Inc., 483 F.3d 470, 474 (7th Cir. 2007) (forbearance of contractual right to terminate license agreement by general creditor

d. Ordinary Course of Business Exception.

A second exception under § 547(c) is known as the ordinary course of business exception. That section provides:

> **(c)** The trustee may not avoid under this section a transfer —
>
> . . .
>
> **(2)** to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was--
>
> **(A)** made in the ordinary course of business or financial affairs of the debtor and the transferee; or
>
> **(B)** made according to ordinary business terms.[142]

Thus, the three elements to the ordinary business exception are: (1) that the debt which was paid by the transfer had been incurred in the ordinary course of business between the debtor and transferee; (2) that the transfer was made in the ordinary course of business between the debtor and transferee; and (3) that the transfer was made according to ordinary business terms.[143] The Bankruptcy Code does not define "ordinary course of business" or "ordinary business terms" and the legislative history has been labeled "sparse."[144] However, it is established that § 547(c)(2) is intended "to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or creditors during the debtor's slide into bankruptcy."[145] The second element, that the transfer was made in the ordinary course of business between the debtor and the transferee, is directed at "[w]hat is subjectively ordinary between the parties [which is determined by] comparing and contrasting the timing, amount, manner and circumstances of the transaction against the backdrop of the parties' traditional dealings."[146] By contrast, the third element, that the transfer was made according to ordinary business terms, "is an objective determination.… [which] compares and contrasts the particular

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did not constitute "new value" for payment of licensing fees within 90 days of bankruptcy); *In re* Eleva, Inc., 235 B.R. 486, 489-90 (10th Cir. BAP 1999) (same).

[142] 11 U.S.C. § 547(c)(2) (West 2004 & Supp. 2009).

[143] Morris v. Kan. Drywall Supply Co. (*In re* Classic Drywall, Inc.), 121 B.R. 69, 74 (D. Kan. 1990) (citing Fid. Sav. & Inv. Co. v. New Hope Baptist, 880 F.2d 1172, 1177 (10th Cir. 1989)).

[144] *Id.* at 75 (quoting *In re* Fulghum Constr. Corp., 872 F.3d 739, 743 (6th Cir. 1989)).

[145] *Id.* (quoting *In re* Energy Co-op, Inc., 832 F.2d 997, 1004 (7th Cir. 1987)).

[146] *Id.*

transaction against the 'practices' or 'standards' of the industry."[147] These inquiries are necessarily fact-intensive and unique to the parties and industry involved.[148]

Those principles were applied in *In re Classic Drywall*[149] to hold that payments which the debtor, a drywall contractor, made to its supplier within 90 days before filing a Chapter 7 bankruptcy petition were made in the ordinary course of their business dealings and hence came within the § 547(c)(2) exception. The debtor had purchased drywall supplies for a period of approximately ten years on open account. In accordance with its longstanding billing practices, the supplier invoiced the debtor once a month on the following terms: "discount 2% by the 10th [day], net on the 20th [day]."[150] The supplier, however, permitted the debtor to pay as much as 120 days later as was its custom with large accounts. The parties' payment practices were also consistent with the practice in the industry generally. Nevertheless, the bankruptcy court held that the payments were not made in the ordinary course because the supplier allowed the debtor to make payments later than required by its formal policy as stated on its invoices and that such forbearance was an exercise of discretion, unbound by any definite standard, which was far to vague a basis on which to conclude that the practice conformed to ordinary business terms.[151]

Reversing, the district court held that the bankruptcy judge's view of the law was too narrow.[152] The lateness of payments was only one element to consider.[153] The touchstone was whether the parties' practice did in fact conform to the industry standard, and if so, the practice came within § 547(c)(2)(B): "The courts have universally accepted industry practice as the meaning of 'ordinary business term.'"[154] Based on the uncontroverted evidence of the ordinary practice of the parties and the industry, the court concluded that the challenged payments came within the § 547(c)(2) exception as a matter of law.[155]

The payment practices in *In re Classic Drywall* typify the manner in which contractors purchase and pay for materials, and thus the case should be helpful to the surety when faced with preference claims aimed at the principal's payments to suppliers. The requisition and

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[147] *Id.* (citing *In re* SPW Corp., 96 B.R. 683, 687 (Bankr. N.D. Tex. 1989); *In re Magic Circle Energy Corp*, 64 B.R. 269, 272 (Bankr. W.D. Okla. 1986)).

[148] *See, e.g.*, *In re* Unimet Corp., 85 B.R. 450, 453-54 (Bankr. N.D. Ohio 1988) (denying trustee's motion for summary judgment based on insufficient evidence of the industry standard practice for paying invoices); *but see* Precision Walls, Inc. v. Crampton, 196 B.R. 299 (Bankr. E.D.N.C. 1996) (affirming bankruptcy court's finding that ordinary business exception did not apply where subcontractor faxed letter to debtor threatening to seek payment from the project owner if not paid immediately).

[149] 121 B.R. 69 (D. Kan. 1990).

[150] *Id.* at 72 (quoting the invoice terms).

[151] *Id.* at 73-74.

[152] *Id.* at 75-77.

[153] *Id.* at 76 (quoting *In re* Xonics Imaging Inc., 837 F.2d 763, 767 (7th Cir. 1988)).

[154] *Id.* at 78.

[155] *Id.* at 79.

payment process by which contractors normally obtain and pay for the services of subcontractors is also standard in its broad outlines, and the surety should be able to resist the trustee's attempt to recover payments to subcontractors on the basis of § 547(c)(2) when those payments are in the ordinary course of business.

CONCLUSION

The principal's decline into bankruptcy can revive liabilities which the surety believed had been discharged by the principal. Faced with the prospect of such a revival, the surety will want to retain any collateral it possesses. The surety's right to do so may be limited by potential liability for conversion. By including certain provisions in agreements with the principal, the surety may be able to minimize that danger. In addition, when the principal has filed for bankruptcy, the surety may be able to act to prevent the trustee from forcing the obligee to disgorge payments made by the principal. Through either strategy, the surety may be able to retain it security for an unexpected loss.