

ELEVENTH ANNUAL SOUTHERN SURETY AND FIDELITY CLAIMS CONFERENCE

SUBSEQUENT REMEDIAL MEASURES

**How to Handle the Typical (and Not So Typical) Occurrences in
Your Principal's Bankruptcy Case**

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I. INTRODUCTION

This outline provides a plan of action for the surety when its principal/contractor¹ becomes a bankruptcy debtor. In most cases, the principal and surety relationship will turn adversarial, or at best strained, upon the filing of a petition by the principal for bankruptcy protection under chapter 11 or chapter 7 of the United States Bankruptcy Code.² In some cases, however, the surety, the principal and the owner may be able to work together in a cooperative fashion for the common goal of completing the bonded construction projects. In section II, we will focus on the procedural devices the surety should use to assure that it maximizes its bankruptcy recovery in an adversarial bankruptcy context. We will then address the likely occurrences in a cooperative setting, particularly the best means of handling a debtor's post-petition financing requests in section III. Finally, in section IV, we will briefly discuss how to appropriately handle the competing claims of two potential third party adversaries - the Internal Revenue Service and secured lenders.

A. The Commencement of the Case

Although it is difficult to identify the typical bankruptcy case of a bonded construction company, a large percentage of cases filed by construction companies start out as chapter 11 reorganizations. There is, however, a general recognition among bankruptcy practitioners that construction companies cannot be successfully reorganized. Although there are several possible explanations for this, the most likely is that construction companies tend to be highly leveraged, closely held entities that possess very few unencumbered assets, without sufficient capital to fund a viable plan. When the debtor cannot be successfully reorganized, the bankruptcy case is typically converted to a chapter 7 liquidation, or the case is dismissed.

Usually the debtor has not conducted a great deal of pre-petition planning nor considered workout strategies involving the surety, rather the surety has itself discovered several red flags foretelling the doom of its principal, namely, increased claims activity and perhaps notification of default from one or more project owners. In some instances, the principal will also show an increased unwillingness to provide pertinent financial information.

At the commencement of the case, the principal is usually a party to one or more executory (incomplete) construction contracts and the surety has issued both payment and performance bonds in connection with those contracts. The principal and most likely its

¹ Hereinafter the principal/contractor shall be referred to as the "debtor" or the "principal," depending on the context.

² All references to the United States Bankruptcy Code or the Bankruptcy Code refer to Title 11 U.S.C. ' 101, *et seq.* All references to the Bankruptcy Rules refer to the Federal Rules of Bankruptcy Procedure.

individual owners have executed indemnity agreements in favor of the surety to induce the surety to issue the bonds. By the terms of the indemnity agreements, the principal has purportedly assigned to the surety all of the principal's rights in the construction contracts, and any sums that become due under any and all of the principal's contracts, whether bonded or not. Typically the surety has not filed a UCC financing statement to perfect a security interest in the assigned contracts.

B. The Surety's Principle Objective Post-Petition

After paying several payment bond claims and also preparing to discharge its performance obligation, the surety is likely to be out for blood, or, put another way, will be looking to be made whole. Unfortunately, a bankruptcy court is not a great venue for one seeking such an outcome.³ The surety's principle objectives in bankruptcy ought to be assuring that 1) contract funds,⁴ either in the hand of the debtor or the owners, are used to pay subcontractors and suppliers, and 2) the incomplete construction projects are timely completed. The surety's most powerful means of reaching these objectives in bankruptcy are its right of equitable subrogation and several procedural devices discussed below. However, as an initial matter, the surety must first take the position that the contract funds are not property of the bankruptcy estate.

C. Are Contract Funds Property of the Estate?

Section 541 of the Bankruptcy Code mandates that an estate is created at the commencement of the case, which consists of certain defined property. The property of the debtor's estate includes all of the debtor's "legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1).

After having discharged its payment obligations, the surety will want to take hold of the contract funds, especially those funds that have been in part "earmarked" for the subcontractors and suppliers whose claims the surety has satisfied. The surety, particularly if it is somewhat familiar with the Pearlman doctrine,⁵ will urge that the contract funds ought not be considered property of the bankruptcy estate. The question of whether contract funds become property of the bankruptcy estate is ultimately controlled by state law. Barnhill v. Johnson, 503 U.S. 393, 398 (1992); Butner v. United States, 440 U.S. 48, 55 (1979).

³ A bankruptcy practitioner representing the surety must be prepared to investigate avenues for third party recovery against architects, engineers, accountants and other agents. These sources are likely to be a better means of making the surety whole. For example, the Florida Supreme Court has opened wide the flood gates for third party litigation against accountants. See First Florida Bank, Inc. v. Max Mitchell & Co., 558 So. 2d 9 (Fla. 1990) (the Court, relying upon the Restatement of Torts section 552 (1977), provided for a third party claim against an accountant to "those persons or classes of persons [whom the accountant] knows and intends will rely on his opinion, or whom he knows his client intends will so rely"). This topic is covered in significantly more detail in Alberta L. Adams' article below.

⁴ The term "contract funds" will be used rather loosely to mean the paid and unpaid contract balance, including progress payments, the final payment and retainage.

⁵ Pearlman v. Reliance Insurance Co., 371 U.S. 132 (1962). In Pearlman, the Supreme Court held that, where the surety has discharged its bonded obligation, the contract retainage will not be considered part of the bankruptcy estate up to the full extent of the surety's payment.

Bankruptcy courts applying state law in various jurisdictions have reached wildly different results when considering whether contract funds are estate property. However, as one practitioner points out,⁶ the outcome of the issue appears to hinge upon two separate factors: 1) whether the debtor's case is a chapter 7 or chapter 11 case, and 2) whether the contract funds are deemed progress payments or retainage.

1. Chapter 11 Case: Progress Payments

Where a chapter 11 debtor has recently filed its petition and is still "performing" its bonded contracts, the bankruptcy court will likely deem the contract funds property of the estate. See Great American Ins. Co. v. Universal Builders, Inc. (In re Universal Builders), 53 B.R. 183, 187 (Bankr. M.D. Tenn. 1985) (holding that progress payments are property of the debtor's estate); American States Ins. Co. v. Glover Construction Co., Inc. (In re Glover), 30 B.R. 873, 882 (Bankr. W.D. Ky. 1983) (holding that while progress payments earned by a debtor performing the bonded contracts were property of the estate, the surety had an interest in the progress payments that could be adequately protected.) Fortunately, the surety may still be able to exercise some control over the progress payments as discussed below.

2. Chapter 11 Case: Retainage

Under most typical circumstances, the retainage will not be considered a part of a chapter 11 debtor's bankruptcy estate, where the surety has paid subcontractors and suppliers. The surety will be entitled to the retainage to the full extent of its payment bond loss. See First Indemnity of America Ins. Co. v. Modular Structures, Inc. (In re Modular Structures), 27 F. 3d 72 (3rd Cir. 1994). Pearlman remains good law in support of the position that the retainage must be used to reimburse the surety.

3. Chapter 7 Case: Progress Payments or Retainage

If the principal's chapter 11 case has been converted to a chapter 7 case or was a chapter 7 case to begin with, the bankruptcy court should consider any progress payments to be simply part of the remaining contract funds. In a chapter 7 context, a surety having discharged its performance bond obligation, payment bond obligation, or both, should be entitled to both the progress payments and retainage to the full extent of its payment. See Mendelsohn v. Dormitory Authority of the State of New York (In re QC Piping), 225 B.R. 553, 566 (Bankr. END. N.Y. 1998) (a majority of bankruptcy courts "have concluded that retainage is not property of the debtor-contractor's estate where there has been a pre-petition default and a surety has stepped in under its bond."); United Pacific Ins. Co. v. Mottner (In re Massart), 105 B.R. 610, 613 (Bankr. W.D. Wash. 1989) (the trustee had no property interest under section 541 on the date of the debtor's bankruptcy case where the surety's payment to subcontractors and suppliers far exceeded the remaining progress payments and retainage); see also MCA Ins. Co. v. Genson (In re Caddie Construction), 125 B.R. 674 (Bankr. M.D. Fla. 1991).

If the surety finds itself in a jurisdiction likely to follow the Glover and Universal cases cited above, the surety is not without recourse. The surety may still argue that the contract

⁶ George J. Bachrach and Cynthia E. Rodgers-Waire, *The Surety's Rights to the Contract Funds in the Principal's Chapter 11 Bankruptcy Case*, 35 Tort and Ins. L. J. 1 (1999). This is a comprehensive journal article that should be useful to sureties and practitioners alike.

funds are trust funds and thus are not a part of the bankruptcy estate. Whether a trust has been established is a question to be resolved by state law. The bankruptcy practitioner must review the general indemnity agreement, the contract documents and any applicable statutory or case law to determine whether the contract funds may be deemed trust funds. Depending on its language, the surety may be able to argue that the general indemnity agreement creates an express trust over contract funds at the time the bonds are issued. Further, after researching applicable federal or state law, the surety may also find that at least a portion of the contract funds are deemed trust funds held in favor of the owner, subcontractors and suppliers under a constructive trust theory.⁷

D. Equitable Subrogation

The backbone of the surety's claim to the contract funds is the right of equitable subrogation. The theory of equitable subrogation recognizes the surety's right to stand in the shoes of the owner/obligee, the contractor/principal and the subcontractors/suppliers *vis-à-vis* the various construction contracts, the contract funds, and the projects themselves, once it has discharged its bonded obligation. Bankruptcy courts in many jurisdictions have recognized a surety's enforceable right of equitable subrogation under applicable non-bankruptcy law. Caddie, 125 B.R. at 678; In re Eastern Marine, Inc., 104 B.R. 421 (Bankr. N.D. Fla. 1989); Equibank v. Ram Construction Co. (In re Ram Constr., Inc.), 32 B.R. 758, 761 (Bankr. W.D. Pa. 1983); Glover, 30 B.R. 873; see also Transamerica Ins. Co. v. Barnett Bank of Marion County, N.A., 540 So. 2d 113 (Fla. 1989).

In most instances, the surety's right of equitable subrogation relates back to the creation of the suretyship relationship, even though the surety's claim may arise only after the principal's default and after the surety has discharged the principal's obligations under the contracts.⁸ Eastern Marine, supra; Phifer State Bank v. Detroit Fidelity & Surety Co., 97 Fla. 538, 543-44, 121 So. 571, 573 (1929). The surety's equitable subrogation rights are not limited to the rights it obtains by standing in the debtor's shoes, however, but extends also to those obtained by stepping into the shoes of subcontractors and suppliers who have been paid by the surety and to those obtained by stepping into the shoes of the bonded project owners.⁹

⁷ For a more detailed discussion, see Bachrach and Rogers Waire, supra Note 6, at 13-20.

⁸The surety's losses arise as and to the extent it discharges its principal's obligations to the principal's creditors, e.g., its subcontractors/suppliers. In particular, courts should recognize equitable subrogation where the following elements are present:

- (a) an agreement of suretyship exists between a surety and its principal/debtor;
- (b) pursuant to such agreement, the surety has been required to discharge various payment and performance obligations of a debtor in connection with bonded projects;
- (c) the surety has fully or substantially paid the claims made against the various payment bonds and the surety has rendered performed or paid as required under the various performance bonds issued pursuant to the suretyship agreement in connection with any bonded projects; and
- d. the application of the doctrine of equitable subrogation is appropriate and would not be unjust based on the facts of the case.

⁹ Equitable subrogation should be permitted where the debtor fails to demonstrate the existence of any factors that would render the application of the doctrine of equitable subrogation unjust and where the surety has acted in good faith in satisfying its bond obligations and by law and, further, where any disagreements between the debtor and the surety concerning the surety's handling of particular bond claims are insufficient to show bad faith or malfeasance on the part of the surety. Employers Ins. of Wausau v. Able Green, Inc., 749 F. Supp. 1100 (S.D.

Transamerica Ins. Co. v. Barnett Bank, *supra*.

As a general matter, a surety may not aggregate its losses on different contracts to enhance its ability to recover by right of equitable subrogation funds due under one particular contract. However, a surety may so aggregate where a common property owner is involved. Transamerica v. United States, 989 F. 2d 1188 (Fed. Cir. 1993) (recognizing the surety's right to cross-collateralization); United States Fidelity & Guar. Co. v. Housing Auth. of the Town of Berwick, 557 F. 2d 482 (5th Cir. 1977). Any recovery realized by the surety that exceeds its loss on a particular bonded project (except where aggregation of losses is permitted) will have to be paid over to the bankruptcy estate. As a creditor, of course, the surety is entitled to share *pro rata* with other creditors in any distribution by the estate.

II. UNILATERAL PLAN OF ACTION FOR THE SURETY WHEN A BANKRUPT PRINCIPAL IS UNCOOPERATIVE

Armed with its right of equitable subrogation, the surety is ready to take an aggressive position in its principal's bankruptcy case. The surety should first attempt to gather as much relevant evidence it can from the principal, the owners and the public record.

A. Report and Information Gathering

At the early stages of the principal's bankruptcy case, it will be critical to have current information regarding the bonded projects, unpaid subcontractors and suppliers and potential claims. To properly evaluate the claims, the surety will be benefited by an immediate examination of the debtor's books and records. Although the surety may have a contractual right to such information, an uncooperative debtor will probably not provide the information willingly or on a timely basis. Therefore, the following are suggested avenues of acquiring information on the debtor.

1. Pull the Bankruptcy Docket/Monitor the Reporting Requirements

Perhaps the best initial sources of information are the schedules and statement of affairs (the "schedules") filed by the debtor at the commencement of the case and the chapter 11 debtor's monthly debtor-in-possession report or, in a chapter 7 case, the chapter 7 trustee's periodic interim reports.¹⁰ This should be the surety's starting point. Most of the federal bankruptcy courts now list bankruptcy dockets on-line. For instance, the bankruptcy docket for the United States Bankruptcy Court for the Middle District of Florida can be accessed through the following web cite: <http://www.flmb.uscourts.gov/paccess.htm>. From the docket, you can identify the schedules and the monthly reports and order copies from the court.

By starting out with the schedules and reports, the surety can often get a good feel for the status of the projects and the principal's proposed use of the contract funds. Often a surety

Fla. 1990); Thurston v. Int'l. Fidelity Ins. Co., 528 So. 2d 128 (Fla. 3d D.C.A. 1988); and Waterhouse v. McDevitt & Street Co., 387 So. 2d 470 (Fla. 5th D.C.A. 1980).

¹⁰ The debtor has, at the latest, 15 days after the filing of its voluntary petition for bankruptcy relief to file its schedules.

will find that its principal has misidentified progress payments as “accounts receivable” in its monthly debtor in possession reports and schedules. In other words, the debtor is using, or plans to use, contract funds to fund its entire reorganization without making proper payments to the subcontractors and suppliers. The schedules and any available monthly reports are also valuable pieces of information to review and take with you to the 341 meeting of creditors.

2. Attend the Creditors' Meeting

An opportunity to at least briefly question the principal debtor arises at the section 341 meeting of creditors. The section 341 meeting is a forum where the United States Trustee and the principal's creditors may question the debtor under oath.¹¹ The creditors' meeting is scheduled shortly after the bankruptcy petition is filed. Notice of the meeting will be provided to all creditors. It is advisable to bring your own court reporter.

Typically, the section 341 meetings are handled in a “cattle call” fashion, with several meetings held during the same hour. However, in some instances, a surety can convince the trustee to continue the section 341 meeting and require a more detailed examination where the debtor might be asked to furnish more relevant documentation, including pay applications, progress reports and other detailed accounting information concerning the incomplete projects and contract funds paid.

3. Schedule a Bankruptcy Rule 2004 Examination of the Debtor

The surety may file a motion or application for a Rule 2004 examination of the debtor immediately upon the commencement of the principal's bankruptcy case. A Rule 2004 examination of the debtor operates much like a deposition of the debtor and bankruptcy courts routinely permit Rule 2004 examinations of debtors early on in bankruptcy cases. An example of a Rule 2004 motion, with attached comprehensive document request, is attached as Exhibit "A."

Pursuant to Rule 2004, the surety is entitled to request the bankruptcy court to enter an *ex parte* order directing the debtor (either in the person of particular principal or manager or the debtor, generally) to submit to an examination, on a date and at a time and place so designated and, further, directing the debtor to produce for inspection and copying certain documents prior to the examination.¹² The scope of the Rule 2004 examination is very broad. The examination must only relate to the acts, conduct or property or to the liabilities and financial condition of the debtor's estate, and other similar issues. In a chapter 11 case the examination of the debtor may also relate to the operation of the business and the source of any money or property acquired or to be acquired by the debtor for purposes of consummating a plan and other matters relevant to the case or formulation of a plan of reorganization. Bankruptcy Rule 2004.

¹¹ If the case started out in chapter 7 or has been converted to a chapter 7 case, the chapter 7 trustee will conduct the examination.

¹² The Advisory Committee notes to Rule 2004 suggests that the request for an order for examination may be heard *ex parte* by application or motion and granted as a matter of course. Advisory Committee Note, Rule 2004, Fed. R. Bankr. P. Check your local rules or bankruptcy judges particular preferences.

Suggested areas of questioning for the Rule 2004 examination of the debtor in a typical adversarial situation are as follows:

- i. whether the claims on the payment and performance bonds are valid;
- ii. whether any defenses or offsets to the claims exist;
- iii. whether the debtor is entitled to extras or additional compensation from the owners who are now making demands on the performance bonds;
- iv. the extent of completion of the bonded projects to date and the work needed to complete the bonded projects and the cost thereof;
- v. the identity of the various subcontractors and suppliers and the terms of their contracts with the debtor;
- vi. the payments made pre-petition or post-petition under the contracts, the cash on hand, and the debtor's actual or contemplated use of cash in the short term; and
- vii. generally, the acts, conduct, or property or liability and financial condition of the debtor and any matters which may affect the administration of the debtor's estate.

Further, a request of documents to be produced at or prior to the Rule 2004 examination might include:

1. the latest financial statements of the debtor (or an internal adjusted financial statement or unadjusted trial balances);
2. a reconciliation of segregated cash accounts showing the current balance, the amount held by job and by subcontractor/vendor within each job;
3. recent bank statements of the debtor with deposit tickets and cancelled checks;
4. recent general ledgers (with key to accounting codes);
5. submittals/shop drawings;
6. requests for information to owner or architect;
7. back charges to subcontractors with supporting documents;
8. correspondence to and from owner, architect or regulatory agencies;
9. warranties and guaranties;
10. inspection and test results;
11. building permits and inspections;
12. time schedules;
13. proposals and proposal requests;
14. requests for extension of time;
15. contracts, subcontracts, supply contracts, and purchase orders;
16. change orders, both approved and requested, and supporting documents;
17. copies of any detail job cost reports showing individual payments to subcontractors/vendors with invoice or check number, amount and cost

- code;
18. copies of any subcontract/purchase order control report showing invoices, payments and retainages held on each subcontract/purchase order;
 19. copies of latest invoice/draw request from all subcontractors and latest statement from all vendors on certain bonded projects, supporting documents for any contract amounts due to and/or back charges against subcontractors and suppliers not included on a list of accounts payable;
 20. a current list of accounts payable, showing vendor name, invoice number and amount;
 21. a summary of amounts currently due from owners, identified between receivables and retainages;
 22. a list of each subcontractor and/or supplier who has a contract/purchase order on the job;
 23. a detailed job cost report showing the actual cost incurred to date on the job, along with a list of unpaid invoices that are included in the report and unpaid invoices (separating payables and retainages); and
 24. name, amount and supporting documents for any contested amount due to and/or bank charges against subcontractors or suppliers not included on any list of accounts payable.

Thus, by seeking a Rule 2004 examination of the debtor early in the bankruptcy case the surety may have an opportunity to examine the debtor in depth on all aspects of bonded projects and related issues. Significantly, the examination may be requested and granted on an expedited or emergency basis and even prior to commencing any litigation against the debtor.

B. Immediate Assumption/Rejection of Executory Contracts

The surety will want to analyze the completion status of its bonded projects immediately upon the principal's bankruptcy filing. Pre-petition bonded project contracts that remain incomplete are considered in the bankruptcy context to be executory contracts. Section 365 of the Bankruptcy Code deals with executory contracts. An executory contract is not defined in the Bankruptcy Code, but is described generally as one to which "performance remains due to some extent on both sides." *Collier on Bankruptcy*, § 365.02, p. 365.17 (15th ed. 1994). Those contracts, which were validly terminated pre-petition, are not considered executory.¹³ The Bankruptcy Code requires that the debtor decide whether to assume or reject any executory contracts prior to confirmation of the debtor's plan of reorganization.¹⁴ Because of the delay inherent in the assumption period, it is virtually always in the surety's interest to seek to shorten

¹³ Note, however, that the Debtor may attempt to challenge the effectiveness of the pre-petition termination.

¹⁴ Certain types of executory contracts, including non-residential real estate contracts, must be assumed or rejected by the Debtor within 60 days after the petition date. 11 U.S.C. § 365(d)(2).

the time to assume or reject the executory contract.¹⁵ An example of a surety's motion to shorten the time for the debtor to seek to assume or reject executory contracts is attached as Exhibit "B."

When seeking either to assume or to reject an executory contract the debtor must demonstrate that, in the exercise of its reasonable business judgment, the assumption or rejection of the contract will benefit the bankruptcy estate. *Collier on Bankruptcy, supra*, & 365.03. If assumed, the debtor will need to promptly cure any existing monetary and non-monetary defaults under the executory contract and the debtor must demonstrate that it can provide adequate assurance of future performance under the contract. 11 U.S.C. ' 365.

In a typical situation, the debtor will likely not have sufficient funds to cure its defaults on all of the contracts and the net cost to the debtor of completing the contracts likely will be in excess of the balance to be paid to the debtor. Thus, bonded project contracts may represent a burden to the debtor's estate. Unless the debtor promptly elects to assume or reject the contracts and associated subcontracts or purchase orders, the total liabilities of the debtor's estate will increase substantially because the claims of the debtor's pre-petition and post-petition creditors will increase. The surety's exposure under its payment and performance bonds will obviously likewise increase.

Accordingly, the surety should request the court to enter an order fixing a date certain by which the debtor is required to assume or reject the contracts and the associated subcontracts and purchase orders for each respective bonded project. Further, for each contract the debtor intends to assume, the surety should request the court to require the debtor to furnish a written statement with the motion to assume indicating when and how the debtor intends to cure the defaults. Additionally, the debtor should be required to provide the surety a monthly accounting of all monies received post-petition in respect of all contracts for bonded jobs on which there is any balance owed or paid to the debtor whether or not the contract has been completed. Further adequate protection, including a right to inspect the books, records and job sites as to all bonded jobs of the debtor upon short notice should also be requested. Finally, if the debtor files a motion to reject any bonded job contract or fails to timely file a motion to assume any bonded job contract, then the surety should be entitled to have the automatic stay lifted as to such contract and bonded project upon the *ex parte* filing of an affidavit and proposed order.

C. Establishing Rights and Priorities to Disbursed and Undisbursed Bonded Contract Funds

Whether disbursed or undisbursed, it is critical for the surety to establish its rights, priorities and the principal's intended use of the bonded contract funds once its has defaulted and filed a bankruptcy petition. By separate motions, the surety may request relief from the bankruptcy automatic stay to authorize the surety to terminate contracts, to relet the job, to prohibit or restrict the debtor's use of the contract funds or, alternatively, an order requiring the debtor to provide the surety adequate protection of its interests. Given the urgency of the particular circumstances there may well be just cause for the surety to request and the bankruptcy court to consider these matters on an emergency basis.

¹⁵ Note that the debtor's executory contracts are considered Section 541 property of the estate. 11 U.S.C. ' 541. Any actions related to property of the estate, including actions related to the contracts, are stayed by Bankruptcy Code's section 362 automatic stay. 11 U.S.C. ' 362. Therefore, any action by an owner or the surety to terminate or relet the contract is stayed by the bankruptcy filing. A surety's request for relief from the automatic stay is discussed further below.

1. Motion to Prohibit or Condition Use of Cash Collateral

A principal's bankruptcy filing may be a signal that the principal has misused bonded contract funds (described in bankruptcy as "cash collateral"). As mentioned above, a debtor may have received funds under the contracts but failed to pay all sums due to the subcontractors and suppliers it was supposed to pay from such funds.¹⁶ The debtor may also have diverted bonded project contract funds to pay labor or materials on the debtor's other non-bonded projects or to cover other operational expenses. Further, there may be additional undisbursed contract funds in the form of progress payments or final payments still in the hands of the owners.

Therefore, a surety should take action to prevent the debtor's continued use and receipt of contract funds without either the surety's express consent or order of the bankruptcy court. Section 363 of the Bankruptcy Code may be used to seek entry of an order granting the surety certain protections as to its cash collateral, the contract funds. The surety should seek entry of an order from the bankruptcy court prohibiting or conditioning the debtor's use of contract funds already in its possession and prohibiting or conditioning the debtor's use of funds yet to be received from bonded projects on the basis that without such protection, the surety will be irreparably injured and its property and contract rights will be damaged, for which the surety will have no adequate remedy. In the event the court declines to prohibit the debtor's use of the cash collateral, the surety would request the court to require the debtor to furnish adequate protection to the surety of its interest in the cash collateral.

There exists legal authority for the proposition that a surety is entitled to adequate protection of its right to contract funds even before it has satisfied its bond obligations. Caddie, supra; In re Eastern Marine, supra, Ram, supra.

Adequate protection available to a surety may include the following:

- (a) requiring the debtor to provide the surety an accounting of all funds received or paid under or in connection with the contracts since default;
- (b) requiring the debtor to segregate funds received or to be received on the contracts in separate interest bearing accounts, one account per respective bonded project;
- (c) directing the debtor to use the funds received or to be received on the contracts solely for the payment of labor, services and materials reasonably necessary to complete work on the respective contract and specifically prohibiting the debtor from using such funds for any other purpose;
- (d) requiring the debtor to provide to the surety each week an accounting of all funds received and all payments made by the debtor under each of the contracts and related subcontracts or purchase orders during the preceding week;
- (e) permitting the debtor to use only such surplus funds received under the contracts as are available from each respective contract and even then: (i) only on the completion of and final acceptance of each respective bonded project; (ii) after payment of all valid

¹⁶ As mentioned above, the surety may uncover such a misapplication after a simple review of the schedules and monthly reports.

- payment or performance bond claims and related expenses as to each contract; (iii) after the discharge of any warranty obligations; and (iv) after first paying from such surplus those items of the debtor's related general operating and overhead expenses which are ordinary and necessary to the continuation of the bonded projects;
- (f) prohibiting any payments to any insiders for any purpose;
 - (g) requiring the debtor to furnish to the surety on a regular basis, without demand, the following information:
 - (i) a monthly construction progress report;
 - (ii) the monthly debtor-in-possession reports;
 - (iii) 30-day, 90-day, and 12-month budgets of bonded projected income and expenses, which budgets should be subject to prior approval of the surety or the court;
 - (iv) a monthly income statement and statement of cash flow;
 - and
 - (v) all notices received from the owners or the subcontractors and vendors on each bonded project.
 - (h) granting to the surety a post-petition lien on, special equity or trust in, and security interest in all cash received or accounts receivable created hereafter in connection with the contracts to the same validity, priority and extent as the surety's pre-petition liens, special equities or trusts, and security interests;
 - (i) requiring the debtor to furnish to the surety proof that all hazard, liability, builders' risk and other insurance required by the terms of the contracts or the indemnity agreement is in full force and effect and further requiring the debtor to maintain such insurance coverage;
 - (j) requiring the debtor to provide to the surety or its authorized agents or representatives full and complete access to inspect the various job sites and to inspect and copy the debtor's business and financial books and records related to the contracts and the respective bonded projects upon reasonable notice;
 - (k) granting to the surety complete relief from the automatic stay in the event of a default by the debtor under the terms of any adequate protection order without a hearing upon 24-hour notice to counsel for the debtor specifying the default; and
 - (l) requiring or specifying such other terms or conditions as may be necessary or appropriate to adequately protect the surety's interest in the cash collateral.

2. Motion for Relief from Stay

Upon the commencement of any bankruptcy case, the bankruptcy automatic stay comes into effect and operates to stay all litigation and creditor action against the debtor and against property of the debtor's estate. 11 U.S.C. §§ 362, 541. The purpose of the automatic stay is to maintain the *status quo* and to prevent further action by creditors that would be inconsistent with the bankruptcy purposes of equal treatment among creditors and a fresh start for the debtor. *Collier on Bankruptcy, supra*, & 362.04, p. 362.35. Unfortunately for the surety

of the principal (turned debtor), the automatic stay does not stay the debtor's unpaid subcontractors, suppliers or project owners from pursuing the surety for payment bond claims or performance bond claims.

However, Section 362(d)(1) of the Bankruptcy Code provides that the automatic stay may be lifted for cause, including the lack of adequate protection. It will probably be critical to all concerned that the surety be permitted to exercise its rights and perform its obligations under the various bonds and indemnity agreements so as to minimize the harm to all parties involved. Therefore, the surety should request that the automatic stay be modified to allow the surety to proceed in its role as surety as to the bonded contracts and bonded projects (together with the related subcontracts and purchase orders), to discharge its performance and payment bond obligations, including reletting the work under the contracts if necessary; to respond to demands by the owners on the bonded projects that are the subject matter of the contracts to complete the bonded projects; and to permit the surety to respond to those persons furnishing labor, services and materials who make demand on the surety for payment under the payment bonds and who have threatened to cease performance or already have ceased performance as a result of non-payment. An example of a relief from stay motion is attached as Exhibit "C."

In proving the cause required to modify the stay, the surety may also be entitled to argue that the principal received funds on certain pre-petition construction contracts prior to the filing of its bankruptcy case, but failed to pay for the labor, services or materials of subcontractors and vendors performing work in connection with such contracts for which those funds specifically were disbursed. Additionally, the subcontractors and vendors under each respective contract may be threatening to abandon their subcontracts or purchase order contracts and cease performance on the respective bonded projects unless they are paid. Further, the debtor's pre-petition and continuing post-petition defaults under the contracts may have caused and will continue to cause harm to the surety, the owners of the bonded projects, and the debtor's subcontractors and vendors. Finally, the surety may be entitled to relief from the automatic stay to exercise its rights and perform its obligations under or in connection with the various bonds and indemnity agreements for cause, pursuant to 11 U.S.C. ' 362(d)(1), including:

- (a) a lack of adequate protection of the surety's interest in the payments made or due to the debtor under or in connection with the contracts;
- (b) an inability on the part of the debtor to successfully reorganize within a reasonable period of time; and
- (c) an inability on the part of the debtor to perform the contracts and the corresponding and ongoing harm suffered by all parties involved.

The surety may also be entitled to relief from the automatic stay pursuant to 11 U.S.C.

' 362(d)(2) where:

- (a) the debtor has no equity in the contracts; and
- (b) the contracts are not necessary to an effective reorganization.

In such cases, the surety should be granted relief from the automatic stay so as to permit it (and the respective owners of the bonded projects) to declare the debtor in default and terminate the contracts, to permit the surety to declare the debtor in default under the

various indemnity agreements, to permit the surety to respond to demands by the owners on the bonded projects that are the subject of the contracts to complete the bonded projects, and to permit the surety to respond to those persons furnishing labor, services and materials who may have made demand on the surety for payment under the payment bonds and who may have threatened to cease performance or already have ceased performance as a result of non-payment.

Additionally, the bankruptcy court may recognize that unless relief from stay is granted on an emergency basis so the surety may address these potential defaults under these contracts, the total liability of the debtor's estate for these claims shall increase substantially to the detriment of the surety and all other creditors. Specifically, a denial of the surety's relief from stay motion will likely increase the amount of pre-petition and post-petition unsecured claims.

3. Motion to Compel

A motion to compel is a seldom used weapon that can be quite valuable in assuring that the debtor does not misapply the contract funds. Because the surety is subrogated to the rights of the owners, subcontractors and suppliers, it may have standing to compel the debtor to do what it is obligated to do under its contract with the owners. In addition, the debtor may move to compel the surety to comply with its federal or state statutory obligations to the owners, subcontractors and suppliers. At the very least, such motion puts the court on notice that the debtor may be misapplying contract funds.

4. Actions as to Owners and any Undisbursed Bonded Contract Funds

Generally, the surety is not at war with the owners. The owners want the project completed on time and for the contract price. Thus, there generally is no need to litigate with the owners unless they simply refuse to pay for the work being performed. If so, the debtor/principal may sue the owners. The surety then will have to decide whether to intervene.

The surety should, however, notify the owner not only of the existing bankruptcy case, but also its claim to the undisbursed contract funds. Attached is a letter the author recently sent to various owners on incomplete projects shortly after the bonded principal filed bankruptcy (Exhibit "D"). One bankruptcy court has already ruled that such notification, assuming it is strictly informational, does not violate the automatic stay. In re Hughs Bechtol, Inc., 117 B.R. 890 (Bankr. S.D. Ohio 1990).

5. Actions Generally Regarding Disbursed and Undisbursed Bonded Contract Funds

Although the bankruptcy court may have already entered orders granting the surety relief from the automatic stay and conditioning the debtor's use of contract funds, the debtor may be non-compliant and may also challenge the surety's entitlement to any additional undisbursed contract funds still in the possession of the various bonded project owners. Also, the bankruptcy court may have taken the position, as some do, that the surety's rights must be determined by way of an adversary proceeding. Thus, the surety, to enforce its rights to the disbursed and undisbursed contract funds, may need to resort to filing an adversary proceeding complaint seeking a court determination of the validity, priority and extent of the

surety's rights to, interests in or liens on the disbursed contract funds and the undisbursed contract funds. The surety may additionally seek to enforce its rights pursuant to Rule 7001 (1), Fed. R. Bankr. P., against the debtor seeking immediate turnover to the surety of the disbursed contract funds. The surety should demand judgment against the debtor determining the allotment of disbursed contract funds presently held by the debtor and directing the debtor to turnover immediately to the surety such amount. Finally the surety may pursue an action within an adversary proceeding pursuant to Rules 7001(7) and 7065, Fed. R. Bankr. P., against the debtor for a preliminary injunction enjoining the debtor from dissipating certain contract funds from bonded construction contracts in which the surety claims a superior right, interest or lien.

If in doubt as to whether a particular bankruptcy judge will require an adversary proceeding to be filed in lieu of or in addition to various motions regarding cash collateral and the like, file them all. A copy of a complaint for determination of validity, priority and extent of the surety's interest or liens and for turnover of property and injunctive relief against the debtor is attached as Exhibit "E." A copy of an order granting injunctive relief is attached as composite Exhibit "F."

III. COOPERATIVE ACTIONS THE SURETY AND BANKRUPT PRINCIPAL MAY TAKE TOGETHER

Section II discussed the more common adversarial relationship between a principal and its surety in a bankruptcy setting. In certain rarer circumstances, the surety may be able to negotiate with the principal/debtor and other interested parties to achieve a cooperative plan of action. Assuming the surety wants the debtor to complete the unfinished project (rather than relet the job), parties may be able to work towards the common goal of completing the bonded project and thereby minimize the surety's losses.

A. Stipulation

Attached as Exhibit "G" is a copy of the actual stipulation entered into by a surety, the owner and the principal/debtor in a case filed in the United States Bankruptcy Court for the Middle District of Florida, Tampa Division, In re Tampa Power Corporation, Case No. 94-08409-8C1. The stipulation was accompanied by a motion filed by the surety for relief from the automatic stay, which was granted. In essence, the stipulation provides for the continuation of the project by the debtor with assurances to the owner, the prime contractor and the surety that their rights will be protected. The cooperative effort described in the stipulation would not work if the surety was bound by the automatic stay.

B. Post Petition Financing

Unfortunately, a savvy principal recognizes the vulnerable position in which it has placed the surety by filing a bankruptcy petition. In most instances, the principal recognizes that it possesses the most inexpensive means for the surety of completing the bonded projects, and will use this fact to garner any leverage it can. Typically, the contractor will request that the

surety waive its claim against the individual indemnitors¹⁷ and may also request that the surety agree to bond new contracts in exchange for its continued willingness to complete the incomplete bonded projects.

In addition, the principal will often request some post-petition financial assistance. Obviously, a surety should not lend money blindly, however, in many instances a surety will ultimately save money if it can prop up its principal long enough for it to complete the bonded projects. A follow-on contractor, recognizing a precarious situation, will typically charge a substantial premium for completing the bonded projects and will often only do the work on an expensive time and materials basis.

When lending additional funds or extending credit, the surety should request that it be given a super-priority expense claim or lien on the debtor's property – whether the property is encumbered or unencumbered. Section 364 of the Bankruptcy Code provides that the debtor can request a super-priority lien in exchange for such financing. Section 364 authorizes the granting of a super-priority lien in specified property under section 364(c) and an administrative priority claim under 364(d) only if the trustee is unable to obtain unsecured credit that would be allowable as an ordinary administrative expense claim under section 503(b). Thus, the debtor must request the super-priority lien and such a request is likely to meet a substantial challenge from other secured creditors. Ultimately, if the surety can loan funds to the debtor on a super-priority basis and closely monitor the debtor's activity while it completes the bonded projects, the surety may greatly diminish its losses.

IV. COMPETING CLAIMS OF THIRD PARTIES

As if things weren't bad enough, a surety can usually expect a difficult time with the IRS and the principal's secured lenders.

A. IRS Tax Liens

In many instances, the principal's bankruptcy filing was not precipitated by project defaults but rather tax problems. The surety will thus often be forced to contend with an additional party claiming an interest in the contract funds – the IRS. In this situation, the surety is likely to find that the IRS has served notices of tax liens on the owners and the owners are holding the contract funds – unsure of whether to pay those funds to the contractor, the surety or the IRS. Sometimes the owner has already paid those funds over to the IRS.¹⁸ It has been the author's experience that there is little reason to attempt to negotiate a resolution with the IRS. Where the IRS is involved, the surety should immediately file an adversary proceeding so the bankruptcy court may determine the validity of the competing claims.

¹⁷ In many instances, this is not a significant concession. Usually the principals of the principal/contractor, who have individually indemnified the surety, file their own chapter 7 or chapter 13 petitions on the heels of the corporate petition. When this happens, the surety is not likely to see a substantial distribution from the estate. Nonetheless, the surety's claim and vote can often make or brake an individual chapter 13, which can make this a valuable negotiating chip.

¹⁸ Although this topic is beyond the scope of this article, a bankruptcy practitioner must be aware of the surety's right to bring a wrongful levy cause of action against the government. The surety must also be aware of the rigid federal statutory limitations placed on such an action. Under the Tax Code, an aggrieved party has only nine months to sue the United States for an improper levy. 26 U.S.C. 6532.

On a federal project, where the government is both the owner and the taxing authority, a payment bond surety's right to the contract funds will be subordinated to the United States' right to a setoff. See United States v. Monsey Trust Co., 332 U.S. 234, 239 (1947); Security Ins. Co. of Hartford v. United States, 428 F. 2d 838 (Ct of Cl. 1970); and Dependable Ins. Co. v. United States, 846 F. 2d 65 (Fed. Cir. 1988) and Aetna Cas. & Sur. Co. v. United States, 845 F. 2d 971 (Fed. Cir. 1988). On the other hand, a performance bond surety's claim to the contract funds will be superior to the United States' claim. Dependable Ins. Co., 846 F. 2d at 67.

On state projects, where there is no right of offset, the surety will almost always have a claim that is superior to the United States. Section 26 U.S.C. 6321 broadly provides that "there shall be a lien in favor of the United States upon all property and rights to property, whether real or personal belonging to the [debtor.]" The United States' lien attaches as of the date the taxes are assessed. Therefore, in order to defeat a tax lien, the surety must first urge that its principal default occurred prior to the date the taxes were assessed and its equitable subrogation rights relate back to the date of default. However, even when a federal tax lien is first in time, section 6323(c) of the Tax Code may still give the surety a super-priority interest in the contract funds that will defeat the tax lien. Section 6323(c) will protect a surety's "security interest" that came into existence after the tax lien to the extent that security interest is "protected under local law against a judgment lien arising, as of the time of the tax lien filing, out of an unsecured obligation." In other words, if under state law the surety's "security interest" (right of equitable subrogation) would be superior to a judgment creditor, it will also be superior to the tax lien, even though the tax lien was first in time.

The author has prevailed against the IRS in an adversary proceeding in bankruptcy court in the state of Florida, arguing that a surety had a super-priority interest under section 6323(c), using as support Transamerica Ins. v. Barnett Bank, 540 So. 2d 1113 (Fla. 1989)¹⁹ and Amwest Surety Ins. Co. v. United States, 870 F. Supp. 432 (D. Ct. 1994). Neither the IRS nor the bankruptcy court was concerned that the Transamerica Court found that a surety's right of equitable subrogation is not a "security interest." The same client, however, was not so fortunate in the Seventh Circuit. In Capitol Indemnity Corporation v. United States, 41 F. 3d 320, 327 (7th Cir. 1994), the court held that the surety was not entitled to prevail under the "super-priority exception" (6323(c)). Because the surety had failed to perfect its security interest under local law against a judgment lien (Illinois law requires sureties to file financing statements in an appropriate office in order to perfect their claim), the surety did not have a claim that would defeat a federal tax lien. Recently, the Ninth Circuit Court has also held that a surety's "equitable subrogation rights" are not entitled to super-priority under 26 U.S.C. 6323(c) because those subrogation rights are not "security interests acquired by contract." Amwest Surety Ins. Co. v. United States, 108 F. 3d 1384 (9th Cir. 1997) (citation omitted).

Needless to say, this is a very complex and treacherous area of the law, however, appropriately prosecuted, the surety has a good chance of prevailing over the IRS.

B. Secured Lenders

The surety's claim against contract funds often attracts the attention of a secured lender of the principal, who also is seeking to be made whole out of the contract funds which have been assigned to the lender as security. Equitable subrogation is similar to an assignment but is governed by equity and arises from operation of law. Dixie Nat'l Bank v. Employers Union

¹⁹ In Transamerica, the Florida Supreme Court held that the surety's equitable subrogation rights were superior to a perfected security interest.

Ins. Co. of America, 463 So. 2d 1147 (Fla. 1985). It is clear that the Uniform Commercial Code does not apply to equitable subrogation. Nonetheless, there may be competition between the secured lender and the surety for any disbursed and undisbursed contract funds.

In deciding the competing interests, some courts have held that a surety's equitable subrogation rights are not UCC assignments and the surety need make no UCC filing to perfect its interests in bonded project funds. See Transamerica v. Barnett Bank, *supra*. Case law is abundant holding that a surety has priority to contract proceeds over a perfected secured lender. *Id.*; Transamerica v. United States, *supra*. The execution of the bond and the principal/debtor's subsequent default are enough to put the surety in the primary position as to entitlement to bonded project funds. In the face of a challenge by a secured lender to the surety's entitlement to bonded project funds, the surety may file an adversary proceeding complaint within the principal's bankruptcy case to determine the validity, extent and priority of the lien or other interest.

V. CONCLUSION

The surety should formulate a plan of action early in a principal's bankruptcy case. Use of a plan, such as described above, may prove to minimize the surety's losses when your principal becomes a debtor.