

ELEVENTH ANNUAL SOUTHERN SURETY AND FIDELITY CLAIMS CONFERENCE

SEVEN MYTHS ABOUT EQUITABLE SUBROGATION

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I.

INTRODUCTION

Those Code based creatures of the law - bankruptcy judges and bank lawyers - hate it, do not understand it, deride it, and perpetually try to find a way around it. The operative indefinite pronoun of which we write is the doctrine of equitable subrogation.

Old as Roman Law and firmly established in Anglo-American Law, equitable subrogation is surely one of the core principles of contract suretyship. After all, the doctrine of equitable subrogation advances an analytical system that determines who gets the money. And as understood by contract sureties and their advocates, application of the doctrine almost invariably yields a favorable result. Thus, sureties and their advocates seek ways to solidify and even expand their equitable subrogation rights. Sureties and their advocates are properly sensitive to what they believe to be judicial and lender hostility. Bankruptcy judges are, on the one hand, properly disposed toward the interests of unsecured creditors; and on the other hand, are often more comfortable in a codified legal environment. Speaking pejoratively (but in good humor), bank lawyers often seem most comfortable in a world of bright lines and square boxes: surely all non-real estate priority issues are resolved by Article 9 of the Uniform Commercial Code.

Whatever the tensions between competing interests, it can now be said that the contract surety's right of equitable subrogation is uniformly if not unanimously recognized. However, given the nature of the real issue - who gets the money - sureties and their advocates would rest comfortably only at their peril.

This paper will consider recent and relatively recent judicial decisions which deal with equitable subrogation issues. While the paper does not purport to be exhaustive in its coverage, we have attempted to select cases with especially interesting and illustrative features. Thus, we consider a case where a Federal Court of Appeals is aware neither of set-off rights infused into AIA form documents nor of the common law right of set-off. We analyze another case from the same court reaching a wholly contrary conclusion, without reference to prior conflicting authorities. Then there is a remarkable case where a Federal Circuit Court of Appeals concludes that equity is no guide in determining the outcome, since both the surety and the bank have compelling equities in their favor. Perhaps most interesting is an unreported Texas decision which expands the surety's equitable subrogation rights to cover payment of unbonded obligations on the theory that same are an integral part of the surety's performance of its bonded obligations.

After analysis of relevant authority, this paper will consider what we believe to be recurring myths about equitable subrogation. While we may not be successful in dispelling all of these myths, we shall at least attempt to provide sureties and their advocates with reasonable arguments and authorities to support a conclusion that the surety get the money.

II.

CASE STUDIES

1. Centex-Simpson Construction Co., Inc. v. Fidelity and Deposit Company of Maryland, 795 F. Supp. 35 (D. Me. 1992)

In *Centex-Simpson Construction Co., Inc. v. Fidelity and Deposit Company of Maryland*, 795 F. Supp. 35 (D. Me. 1992), the United States District Court for the District of Delaware had to decide whether the D'Oench, Duhme doctrine could be invoked by the FDIC as receiver to defeat the claims of a performing Miller Act surety under its right of equitable subrogation. As the *In Re Modular Structures, Inc.* Court had done in the bankruptcy context, the *Centex* Court held that funds owed to a defaulting bond principal never became property of the principal, and thus could not become subject to a security interest in the principal's accounts receivable. *Id.* at 38-39.

In May 1983, the Fels Company, Inc. ("Fels") provided a Maine bank with a security interest in Fels' accounts receivable. *Id.* at 37. The bank perfected its security interest by filing financing and continuation statements with the Maine Secretary of State in May 1983 and March 1988. *Id.* The Federal Deposit Insurance Corporation ("FDIC") was appointed receiver of the bank in 1991.

In September 1988, Fels, as subcontractor, entered into a subcontract with Centex-Simpson Construction Company ("Centex"), the general contractor, to perform mechanical work in connection with a federal construction project. *Id.* Fidelity and Deposit Company of Maryland ("Fidelity") issued payment and performance bonds to cover Fel's subcontract obligations which bonds were required by the subcontract between Centex and Fels. *Id.*

Fels subsequently defaulted in its obligations under the Centex contract, and Fidelity, as surety, was required to pay Centex over \$400,000 pursuant to its performance bond applications. *Id.* at 38. Fidelity also paid over \$200,000 under its payment bond obligations. *Id.* At the time the mechanical subcontract between Centex and Fels was terminated, Centex held approximately \$90,000 in earned but unpaid funds that were to be paid to Fels under its mechanical subcontract. *Id.* Fidelity withheld a like amount from the funds that were due either Centex or Fidelity for the purpose of completing the mechanical subcontract. *Id.*

In January 1991, the bank provided Centex with written notice of its security interests in Fels' accounts receivable and its entitlement to all amounts due and owing from Centex to Fels. *Id.* Subsequently, as receiver for the bank, the FDIC held a judgment against Fels in excess of \$1 million which the bank had obtained in an action for default on four loans from the bank secured in part by Fels' accounts receivable. *Id.*

Faced with the dispute between Fidelity and the FDIC regarding who was entitled to the "earned but unpaid" contract funds, Centex deposited the money it had withheld with

the Clerk of the Court and filed an interpleader action naming Fidelity and the FDIC as parties to the interpleader action. *Id.*

The FDIC argued that the D'Oench Duhme doctrine, codified in 12 U.S.C. section 1823(e), should be invoked to defeat Fidelity's claims to the funds retained by Centex. *Id.* Fidelity argued that title to the funds never passed to Fels because Fidelity became entitled to them pursuant to its surety relationship with Fels and its right to subrogation that arose after Fels defaulted on the Centex contract. *Id.*

Based upon the principles of equitable subrogation announced in *Pearlman*, the Court agreed with Fidelity, holding that the funds never became the property of Fels, and thus could not be an "asset" subject to a security interest, regardless of when the security interest had been perfected. *Id.* at 39-41. The Court held that, under *Pearlman* and its progeny, surety claims arising under construction projects must be satisfied before the subcontractor and its creditors become entitled to any contract funds. *Id.* at 39. The Court reached its conclusion without mention of any provision in the mechanical subcontract providing that final payment is not due until all work is completed and the suppliers and laborers are paid (as had been present in *In Re Modular Structures*). The Court also noted that although *Pearlman* involved retainage, subsequent decisions had extended the doctrine to progress payments such as funds retained by Centex. *Id.* at 40, n.12.

2. Indiana Lumbermens Mutual Ins. Co., Inc. v. Construction Alternatives, Inc., C.2 F.3d 670 (6th Cir. 1993).

In *Indiana Lumbermens Mutual Ins. Co., Inc. v. Construction Alternatives, Inc.*, (*In Re Construction Alternatives*, 2 F.3d 670 (6th Cir. 1993), the Sixth Circuit held that unpaid progress payments under a construction contract were part of the debtor contractor's bankruptcy estate despite payments made by a surety to subcontractors and suppliers under a payment bond naming the debtor contractor as principal.

In May 1990, Construction Alternatives, Inc. ("CA") entered into a contract with an Ohio School District ("School District") to remove asbestos from four of its schools. *Id.* at 673. On April 6, 1990, Indiana Lumbermens Mutual Insurance Company, Inc. ("Lumbermens") issued payment and performance bonds to CA in connection with the project. *Id.*

Pursuant to tax assessments made against CA for unpaid taxes, the IRS filed a notice of tax lien against CA on May 14, 1990 and on August 20, 1990. *Id.* On August 21, 1990, CA filed a petition for Chapter 11 bankruptcy relief. *Id.*

At the time it filed its bankruptcy petition, CA had completed all the work on the asbestos removal project and was due to receive its final progress payment, ultimately determined to be \$39,705. *Id.* However, CA had not paid all of its bills arising under the contract. *Id.* Pursuant to its payment bond obligations, Lumbermens had paid an unspecified amount to at least two unpaid suppliers or subcontractors on the project. *Id.*

Pursuant to a motion filed by CA, the bankruptcy Court ordered the unpaid contract funds to be deposited in a trust account, and provided that any party desiring to assert a

claim was required to file an answer. *Id.* Both the IRS and Lumbermens filed answers claiming an interest in the funds. *Id.* Upon CA's and Lumbermens' cross-motions for partial summary judgment, the bankruptcy Court ruled that the fund was the property of CA's bankruptcy estate to which the tax lien had attached. *Id.* at 673-74. It also held that Lumbermens had no equitable interest in the fund. *Id.* The district Court upheld the bankruptcy Court's decision, and Lumbermens appealed to the Sixth Circuit. *Id.*

On appeal, Lumbermens argues that it was subrogated to the rights of the suppliers, laborers, and contractors that it paid in CA's stead, and that it therefore had an equitable lien on the unpaid progress payment dating back to the date the bonds were issued. *Id.* at 675. The Court conceded that under Ohio law, a surety who pays in the place of a defaulting principal is subrogated to the rights of the parties paid and those whose obligations the surety has discharged. *Id.* However, the Court also considered the well-established maxim that a surety's rights are no greater than the rights of the party to whom it is subrogated. *Id.* The Court then examined the respective rights of all parties to the unpaid progress payment, and determined that even in the shoes of the School District and the unpaid suppliers and subcontractors, Lumbermens had no interest in the funds under Ohio law. *Id.* at 674-75.

First, the Court discussed the rights of the School District to the funds concluding that the "School District had no right, under its contract with CA, to retain any portion of the progress payments to CA pending CA's payments of contractors and suppliers." *Id.* at 675. Under the contract, once the work was performed, the School District was required to pay CA the final payment. *Id.* Since there was no dispute that the work had been performed, the School District had no right to retain the progress payment, and Lumbermens therefore had no claim to the funds through subrogation to the rights of the School District. *Id.*

The Court also discussed Lumbermens subrogation to the rights of the unpaid subcontractors, and determined that under Ohio law, a subcontractor must file a mechanics lien to obligate a government contractor to retain money from contract payments. *Id.* at 676. Since none of the subcontractors paid by Lumbermens had filed mechanics liens, they had no right to the final progress payment, and Lumbermens therefore had no right to the funds through the subcontractors. *Id.*

The Court also held that even if Lumbermens had an equitable lien on the funds, the IRS tax lien had priority over such lien. *Id.* Since the amount of Lumbermens' alleged lien was not certain at the time the tax liens were filed, the tax liens took priority because Lumbermens' lien could not be "perfected" for purposes of the federal tax lien statute at the time the notice of the federal tax lien was filed. *Id.*; citing *United States, ex. Rel. v. McDermott*, 507 U.S. 447, 113 S. Ct. 1526, 123 L.Ed.2d 128 (1993).

3. First Indemnity of America Insurance Co. v. Modular Structures, Ins.
(In re: Modular Structures, Inc.), 27 F.3d 72 (3rd Cir. 1994).

In *In Re Modular Structures, Inc.*, 27 F.3d 72 (3d Cir. 1994), the Third Circuit examined whether the Supreme Court's holding in *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 83 S. Ct. 232, 9 L.Ed.2d 190 (1962), and New Jersey law entitled a surety to

outstanding contract payments and retainage after the principal defaults and subsequently files for bankruptcy or whether such payments and retainage become part of the principals bankruptcy estate.

In February 1989, Modular Structures, Inc. (“Modular”) entered into a contract with the Salvation Army for the design and construction of corporate headquarters in Newark, New Jersey. 27 F.3d at 74. Under the terms of the contract, final payment did not become due until the contractor established that all payments to subcontractors had been made. *Id.* at 75. First Indemnity of America Insurance Company (“First Indemnity”) issued Miller Act performance and payment bonds to Modular in connection with the project. *Id.* In March 1989, First Fidelity Bank (“Bank”) loaned Modular \$1.5 million to enable them to undertake the Salvation Army and other projects. *Id.* The Bank took a security interest in all of Modular’s accounts receivable, contracts and proceeds thereof and properly perfected its lien. *Id.*

Ultimately, Modular was not able to complete all of its obligations under the Salvation Army contract and ceased working on the project. *Id.* At the time, the Salvation Army held unpaid contract proceeds and retainage. *Id.* In March 1991, Modular filed for Chapter 7 Bankruptcy protection and stated in its bankruptcy schedules that the Bank maintained a first, perfected security interest in Modular’s contracts and accounts receivable. *Id.* Later, in August 1991, the Trustee granted the Bank a “Superpriority Lien” in Modular’s accounts receivable and the Bank began pursuing collection of these accounts. *Id.* First Indemnity, as surety, was called upon to pay proper claims of subcontractors, and notified the Salvation Army in April 1991 that it should issue no additional payments to Modular so that any remaining funds due under the contract could be used to cure Modular’s default. *Id.* at 75.

In November 1991, the Bank threatened to institute legal action if the Salvation Army did not turn over the funds it held under its contract with Modular to the Bank. *Id.* at 75. The Salvation Army failed to comply with the Bank’s demand, and the Bank filed a motion for turnover of the funds in Modular’s bankruptcy proceeding. *Id.* After a hearing, the bankruptcy court ordered the Salvation Army to turn over the funds to the Bank on the basis that the contract was not a public contract, and therefore there was no trust fund created to protect the funds. *Id.* First Indemnity appealed to the district court which agreed with the bankruptcy court’s decision that no constructive trust was created by New Jersey common law. *Id.* First Indemnity then appealed to the Third Circuit. *Id.*

First Indemnity’s primary argument on appeal was that because Modular breached its contract with the Salvation Army, none of the funds held by the Salvation Army were owing to Modular and thus could not be properly considered part of the bankruptcy estate, subject to the Bank’s lien and amenable to a turnover order. *Id.* at 76. In reaching this decision, the Court relied primarily on the Supreme Court’s decision in *Pearlman*. In *Pearlman*, which was decided before enactment of the bankruptcy code, a priority dispute arose between the trustee of the bankrupt estate and the surety with respect to contract funds retained by the United States, the owner of the construction contract at issue. The *Pearlman* Court found that because the contractor had defaulted, the funds retained by the

government did not belong to the contractor, but remained property of the owner. *Pearlman* at 371 U.S. at 141,83 S.Ct. at 237. By way of subrogation, the funds became property of the surety to the extent necessary to reimburse it for its payments to laborers and materialmen. *Id.* Thus, the Court held, the funds were not part of the contractor's bankruptcy estate. *Id.*

The Third Circuit concluded that the holding in *Pearlman* had been incorporated into New Jersey law, and that application of its holding meant and concluded that the funds retained by the Salvation Army belonged to First Indemnity and not to Modular. *In Re Modular Structures*, 27 F3d. at 75-80. The Court found that Modular did not fulfill its contractual obligation to pay all of its subcontractors and First Indemnity, as surety for Modular, was required to pay any subcontractor not paid by Modular. *Id.* at 77. The Court further found that the funds held by the Salvation Army must be used to satisfy these claims, either by direct payment to the subcontractors or as payment to First Indemnity as reimbursement for the payments made by the surety. *Id.* The Court determined that if the Salvation Army turned over the monies it is holding to the bankruptcy estate, First Indemnity would have to seek recovery for its payments to the subcontractors only as an unsecured creditor in competition with the other unsecured creditors. *Id.* The Court concluded that such a result was neither contemplated by the contract between Modular and the Salvation Army nor by New Jersey law. *Id.*

In its decision, the Court determined that the adoption of the Bankruptcy Code in 1978 did not serve to undercut *Pearlman's* vitality. *Id.* at 77, n.6. Under *Pearlman*, the funds in question did not become property of the bankruptcy estate by virtue of the doctrine of subrogation and although Congress intended to give the broadest possible scope to what assets become property of the estate under the Bankruptcy Code, it is doubtful that enactment of the Code overturned *Pearlman*. *Id.* In fact, the Third Circuit determined that the funds retained by the Salvation Army were not "property of the estate," as that term is defined by section 541 of the Bankruptcy Code. *Id.* at 76.

The Court also held that contrary to the bankruptcy and district court's conclusions, the *Pearlman* doctrine is not limited to public contracts. The Court determined that the Supreme Court in *Pearlman* had based its holding on common law principles of property rights and subrogation, not upon principles or rights arising from statutes governing public contracts. The Court found nothing in the *Pearlman* Court's reasoning that implied that its doctrine should apply only to public contracts. *Id.* at 79-80.

4. Amwest Surety Ins. Co. v. United States, 870 F. Supp. 432 (D. Conn. 1994)

In *Amwest Surety Ins. Co. v. United States*, 870 F. Supp. 432 (D. Conn. 1994), the United States District Court for the District of Connecticut was faced with the issue of the respective priorities of federal tax liens and a surety's equitable subrogation interest which accrued after the tax liens were filed but arose from a relationship entered into before the tax liens were filed. The Court construed I.R.C. § 6323(c) as giving priority to the surety's equitable subrogation interest.

On May 24, 1991, Amwest Surety Insurance Company (“Amwest”) issued a performance bond naming Credo Housing Development Corporation (“Credo”) and the State of Connecticut as obligees and SMP Developers, Inc. (“SMP”) as principal. The bond was issued to secure performance of a construction contract entered into between Credo and SMP. *Id.* SMP soon began having financial difficulties and, commencing on September 11, 1991, Amwest made more than \$60,000 in payments to fulfill its bond obligations. *Id.* at 433.

Upon default, SMP assigned to Amwest any and all sums due or to become due pursuant to SMP’s contract with Credo. *Id.* The assignment was effective as of the date of each bond, but only in the event of default, which occurred when SMP failed to pay for labor and materials. *Id.*

In the meantime, the IRS had assessed taxes, most recently on June 23, 1991, against SMP in the total amount of \$102,957.82. *Id.* Accordingly, tax liens arose on the dates of the assessments. *Id.* The IRS filed notices of the tax liens with the Connecticut Secretary of State on June 25 and July 31, 1991. *Id.* The total amount of the tax liens covered by the filings was approximately \$66,000. *Id.*

The IRS served Credo with copies of the lien notices on August 5, 1991. *Id.* On August 15, Credo paid the IRS over \$42,000 that had been requisitioned by SMP for July 1991 work under the contract. *Id.* Amwest subsequently filed suit against the IRS, claiming that Amwest was entitled to the money Credo had paid the IRS. *Id.*

Both Amwest and the government filed motions for summary judgment. The question presented to the Court by the cross-motions was “whether the surety’s interest in the contract payments, though not a fully ripened enforceable right when the government perfected its lien, has nonetheless been endowed with a priority which defeats the government’s claim.” *Id.* at 433.

The Court agreed with the parties that I.R.C. § 6323(c), enacted by Congress in 1966, was determinative of the issue. The statute, which dates tax liens to the date notice of the liens is filed, provides in relevant part:

(1) ... To the extent provided in this subsection, even though a notice of a lien ... has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing but which

(A) is in qualified property covered by the terms of a written agreement entered into before tax lien filing and constituting...

(iii) an obligatory disbursement agreement, and

(B) is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

I.R.C. § 6323(c). The government did not dispute that Amwest's bond was "an obligatory disbursement agreement" as contemplated by §6323(c)(1)(B). Amwest at 434. The government did argue, however, that Amwest's subrogation interest was not protected under local law against a judgment lien which has valid and enforceable at the time the tax liens were filed. *Id.* The crux of the government's argument was that Amwest had not filed a financing statement to perfect its security interest as required by Connecticut's version of the Uniform Commercial Code (UCC). *Id.*

The Court disagreed with the government's position and followed its prior holding and rulings by the First and Eighth Circuits standing for the proposition that the UCC simply does not apply to sureties. *Id.*; citing *Balboa Insurance Co. v. Bank of Boston Connecticut*, 702 F. Supp. 34 (D. Conn. 1988); *In re J.V. Gleason, Inc.*, 452 F.2d 1219 (8th Cir. 1971); *Shawmut Bank v. New Amsterdam Casualty Co.*, 411 F.2d 843 (1st Cir. 1969). The Court held that since the UCC does not apply to sureties, Amwest was not required to file a financing statement to perfect its interest in the proceeds of its principal's contract. *Amwest* 870 F. Supp. at 434.

The Court also furnished policy reasons for its holding, pointing out that:

A surety claim is derived from equity and not from a contract, nor the ordinary financing contemplated by U.C.C. art. 9. Further, to create a contract obligation to its principal, a surety would be obliged to expend funds to only then to go unreimbursed if required to file to gain a priority over an earlier filed competing claim. No unfairness results because sureties' involvement in contracts is generally known. An inequity does result if sureties' later expenditures accrue to the benefit of prior claims. If sureties were not reimbursed because they stand in line with other creditors, bonds would not be issued.

Id.

5. Bank One, Texas, N.A. v. Highlands Ins. Co., No. 04-95-00201-CV (Tex. Ct. App. Nov. 13, 1996).

In an official 1996 decision, the Texas Court of Appeals addressed the issue of a surety's equitable subrogation rights and money that it paid for the claims on unbonded contracts, where the surety asserted that payment of these claims was necessary for the performance of bonded contracts. In *Bank One, Texas, N.A. v. Highlands Insurance Co.*, No. 04-95-00201-CV (Tex. Ct. App. Nov. 13, 1996), the Court held that where there was "ample evidence" that performance of bonded and unbonded contracts were connected, the surety had an equitable interest in funds it expended for completion of the unbonded contracts.

James H. Greer Interests, Inc. ("JHGII.") was a Texas construction company involved in the construction of exterior surfaces of office buildings as well as glass jobs and roof decking projects. Bank One, Texas, N.A. ("Bank") made several loans to JHGII and its principal owner, James Greer. *Id.* The Bank secured these loans by perfected security interests in JHGII's accounts, contract rights, and inventory. *Id.* Highlands Insurance

Company and its subsidiary, Highlands Underwriters Insurance Company ("Highlands") issued payment and/or performance bonds on a number of JHGII's construction contracts. *Id.* In exchange for the bonds, JHGII signed a General Indemnity Agreement giving Highlands security interest and its accounts, contract rights, and inventory. *Id.* Highlands security interest was junior to the Bank's security interest.

In the late 1980s, JHGII began to experience severe financial problems. It subsequently informed Highlands of its inability to complete some 14 bonded contracts and assigned Highlands its rights under those contracts. For a three-month period in 1988, Highlands advanced money to finance JHGII's operations while it assessed the situation and evaluated its options. *Id.* The parties referred to this money as "look" or "look see" money. *Id.*

Although a number of JHGII's construction contracts pending at the time Highlands began their financial assistance were bonded, a number of them were not. *Id.* A surety consultant hired by Highlands recommended that Highlands finance the completion of the bonded contracts but not get involved in the unbonded contracts. Highlands made its own determination, however, that JHGII was most likely unable, due to its financial condition, to complete the bonded contracts. *Id.* Highlands also determined that if the unbonded contracts were not completed, "there was a risk that suppliers and subcontractors who were common to the bonded and unbonded contracts would refuse to perform on the bonded contracts." *Id.*

In April 1998, Highlands, JHGII, and James Greer entered into an agreement with respect to the receipt and disbursement of all JHGII bonded and unbonded contract proceeds. While the parties were working out a final agreement, Highlands advanced \$335,000 pursuant to the General Indemnity Agreement. *Id.* The final, comprehensive agreement provided for the establishment of a trust account for the proceeds of the bonded contracts only. *Id.*

Highlands subsequently hired Brown, Carpenter & Company ("BCJV") to complete construction on the bonded contracts and new unbonded contracts. *Id.* Highlands issued bonds to BCJV on the unbonded contracts at no cost and received a right to half of any profits realized on the new unbonded contracts in excess of \$1,200,000. *Id.* Highlands also entered into an agreement with Brown-Carpenter Curtainwall Systems, Inc. ("BCC"), whereby BCC agreed to take an assignment from JHGII of the unbonded contracts. *Id.* Highlands agreed to bear the losses on these contracts up to \$250,000. *Id.*

During May and June, 1989, the Bank foreclosed on JHGII's assets and made a demand on Highlands for an accounting and payment of contract proceeds. The Bank also filed suit to recover proceeds from the bonded and unbonded contracts and the value of JHGII's inventory. *Id.*

Despite the Bank's arguments to the contrary, the trial court held that Highlands was entitled to equitable subrogation for payments it made on bonded and unbonded contract claims. *Id.* The Bank appealed, and the Texas Court of Appeals affirmed the decision of the trial court in all respects.

The first issue addressed by the Court of Appeals was the standard to be applied in determining whether Highlands had equitable subrogation rights in the proceeds at issue. *Id.* Citing numerous decisions in the State of Texas, the Court concluded that the two key elements of equitable subrogation are (1) that the party on whose behalf the claimant is charged at debt is primarily liable on the debt, and (2) that the claimant paid the debt involuntarily. *Id.*, quoting *Argonaut Ins. Co. v. AllState Ins. Co.*, 869 S.W.2d 537, 541-42 (Tex. Ct. App. 1993). The Court further noted that "Texas Courts have been liberal in their determinations that payments were made involuntary". *Id.* The Court determined that in the context of construction contracts, the two key elements of equitable subrogation ultimately lead to an inquiry regarding whether the surety "paid, pursuant to a bound obligation so to do, what in equity should have been paid by the contractor." *Id.* quoting *Trinity Universal Ins. Co. v. Bellmeade State Bank*, 396 S.W.2d 163, 168 (Tex. Civ. App. 1965).

In applying its equitable subrogation standard to the facts before it, the *Bank One* Court determined that Highlands did not voluntarily spend "look" money in making payments in relation to the unbonded contracts. *Id.* In making this determination, the Court concluded that the completion of the unbonded contracts was necessary to the completion of the bonded contracts. The Court stated:

Highlands' performance bonds required it to pay the costs of completing JHGII's bonded contracts. There is ample evidence in the record that the bonded and unbonded contracts shared common suppliers and that if these suppliers were not paid on the unbonded contracts, they would refuse to deliver materials on the bonded contracts, thereby significantly increasing the cost of completing the bonded contracts. Contrary to Bank's assertion, Highlands did not incur expenses relating to the unbonded contracts simply because it "wanted to" or because Greer insisted on it.

Id.

With regard to "look" money, the Court held that payment of such sums was necessary to keep JHGII in operation while Highlands evaluated the situation. *Id.* Failure to pay these sums would have resulted in JHGII not being able to meet its payroll and having its operations interrupted which also would have caused a significant increase in the cost to complete the bonded contracts. *Id.*

The Court went on to note that whether Highlands was ultimately wrong in its belief that the bonded contracts would be adversely affected by failure to complete the unbonded contracts, that mistake alone would not render Highlands a volunteer. *Id.* As long as Highlands had a good faith belief in the connection between the performance of the bonded contracts and performance of the unbonded contracts, they would not be deemed to be voluntarily making the payments on the unbonded contracts. *Id.*

Unfortunately, the Texas Court declined to report this remarkable decision. The Texas Rules of Appellate Procedure, Rule 47.7, provide that "opinion not designated for publication by the Court of Appeals have no precedential value and must not be cited as authority by counsel or a court."

6. Reliance Insurance Co. v. U.S. Bank of Washington, N.A., 143 F.3d 502 (9th Cir. 1998)

In *Reliance Ins. Co. v. U.S. Bank of Washington, N.A.*, 143 F.3d 502 (9th Cir. 1998), the Ninth Circuit was presented with yet another dispute between a surety and a third party regarding priority to contract proceeds. This time, the surety contested a bank's use of contract proceeds to offset a construction loan it had made to the surety's bond principal. *Id.* at 504. The Court rejected the surety's arguments that it was entitled to the proceeds and ruled in favor of the bank.

Kruse Construction ("Kruse") was awarded a government contract to improve a Coast Guard station at Cape Disappointment. *Id.* at 504. Reliance Insurance Company ("Reliance") issued a bond for the project pursuant to the Miller Act, 40 U.S.C. § 270a(a)(2). *Id.* U.S. Bank of Washington (the Bank) provided a construction loan for the project to Kruse. *Id.* Pursuant to an assignment from Kruse to the Bank, the government wired all progress payments directly into Kruse's account at the Bank. *Id.*

By early June 1992, Kruse ran into financial difficulties and several subcontractors had given notice to the surety of unpaid claims. *Id.* On June 23, Kruse declared itself in default, notified the government as such, and consented to payment of any moneys due from the government to Reliance instead of Kruse. *Id.* at 505.

The problem from Reliance's perspective was that the Coast Guard had deposited a \$280,319 check into Kruse's bank account on June 19, 1992. *Id.* at 504. The Bank knew at the time that Kruse was having financial difficulties, but did not know that the subcontractors had not been paid. *Id.* at 505. Reliance did know that the subcontractors had not been paid but did not know that the progress payment had been made. *Id.* Even after being notified by Reliance that it should use the money to pay subcontractors, the Bank applied the full amount of the June 19 progress payment as a setoff against its loan. *Id.* Reliance, stuck with paying the subcontractors and seeking indemnification from Kruse, sued the Bank, claiming that it should have had the benefit of the June 19 payment. *Id.* The trial court granted summary judgment in favor of Reliance, and the Bank appealed. *Id.*

The district court, applying Washington law, held that the Bank had converted the money, because it knew that the contractor was in default before the Bank setoff the payment against its loan and that Reliance accordingly had an equitable lien on the money superior to the Bank's interest. *Id.* The Ninth Circuit not only rejected this claim, but held that Reliance was not entitled to recover the proceeds under any legal theory.

A. Conversion

In addressing the allegation of conversion, the Court decided that the money in question was not a "chattel," which is the traditional subject of conversion. *Id.* Moreover, the Court held that even if the money was a chattel subject to conversion, the Bank did not wrongfully receive the money or have any obligation to deliver it to another. *Id.* Under those circumstances, the required elements for conversion were not present. *Id.*

B. Subrogation

The Court also rejected Reliance's argument that it was subrogated to Kruse's right to recover progress payments from the time Kruse defaulted. *Id.* This Court found that the crucial inquiry in this issue was the timing of the Bank's receipt of the money relative to any payments made by Reliance pursuant to its bond obligations. *Id.* Since Reliance had not paid any subcontractors at the time the Bank received the money, no right of subrogation had arisen. *Id.* The Court stated that "[a]t common law, a surety does not become subrogated to its principal's right to payment from a third party until the surety performs the principal's obligation." *Id.* at 506 (citations omitted).

Reliance further argued that it became subrogated to the contractor's right against the government. *Id.* The Court disposed of this argument with the simple observation that Reliance was making a claim against the Bank and not the government. *Id.*

c. Other Issues

Reliance also argued that Kruse's bank account was impressed with a constructive trust in its favor from the time Kruse breached its contract, and that it was entitled to the proceeds on equitable grounds. *Id.* The Court rejected both of these arguments, pointing out that there was no fraud involved, and that both parties were innocent victims with equal claims under equitable principles. *Id.*

7. Intercargo Ins. Co. v. United States, 41 Fed. Cl. 449 (Fed. Cl. 1998).

The question presented to the United States Court of Federal Claims in this matter was whether a surety's equitable subrogation interests extended to funds obligated for contract performance but not earned by and therefore not due and owing to the principal. Relying on traditional concepts of equitable subrogation, the Court held that the surety had no right to monies not paid or owed to the principal under the contract bonded by the surety.

In September 1993, the Department of the Army awarded a contract to Leonard Wills d/b/a Wills Construction Co., Inc. ("WCC") for the replacement of doors at Fort Rucker Alabama. 41 Fed. Cl. at 450. Intercargo Insurance Company ("Intercargo") issued Miller Act performance and payment bonds to WCC in October 1993. *Id.* at 451.

After the Army issued a Notice to Proceed, WCC purchased doors and related components from H&H Doors and Hardware, Inc. ("H&H") for \$253,000. *Id.* On February 7, 1994, before the doors and accessories were delivered, but apparently after H&H had purchased them from a third party, the Army terminated WCC's contract due to its failure to furnish proof of workers' compensation insurance. *Id.* at 452-53. In January 1994, prior to terminating WCC's contract, the government made a progress payment to WCC in the amount of \$8,632.00. *Id.* at 451. At the time the government terminated the contract, no other payments had been made to WCC, and none were due and owing under the contract, apparently since WCC had performed no further work. *Id.* The government later "de-obligated" the remaining contract balance on July 15, 1994.

At some time subsequent to April 8, H&H made a claim on the Intercargo payment bond which the parties eventually compromised for \$150,000. *Id.* There was no evidence that Intercargo notified the Army of H&H's claim or of the subsequent settlement agreement executed between H&H and Intercargo regarding this claim. *Id.*

In the meantime, WCC had filed a claim in the United States Court of Federal Claims, seeking to have the government's termination of their contract for default converted into a "termination for convenience" which would allow for the recovery of termination costs. *Id.* at 454. However, pursuant to the settlement agreement, the government was to pay no termination costs to WCC. *Id.* By agreement of the parties, WCC's claim was later dismissed with prejudice in exchange for the recharacterization of its termination to a termination for the convenience of the government.

In August 1996, Intercargo filed suit against the United States in the Court of Federal Claims claiming it was entitled to reimbursement from the government for the \$150,000 it had paid to H&H. *Id.*

The essence of the Court's holding was that since no money was owed to WCC by the government under the contract at the time the contract was terminated, Intercargo had no claim against the government. *Id.* at 455-461. The Court found that under long-established principles of equitable subrogation, Reliance "stands in the shoes of the contractor, not the shoes of the laborers and materialmen", and to the extent the government owes the contractor monies for contract performance, the surety, by paying suppliers and materialmen, is subrogated to the contractor's right to those funds. *Id.* at 457. The Court further noted that a surety cannot acquire rights by subrogation greater than the rights possessed by the subrogor. *Id.*

The Court also found it important that H&H apparently had not completed its obligation under its purchase order from WCC, and was thus not entitled to any payments from the contractor at the time the contract was terminated. *Id.* at 458. Although not directly stated by the Court, it is implied that had H&H delivered the doors, Intercargo would have had an equitable subrogation claim, presumably because the government would have owed the contractor for the doors. *Id.*

Intercargo also argued that it should be entitled to step into the shoes of WCC for the purpose of converting the termination of the contract from a "default" termination into a "termination for convenience." *Id.* at 459, n. 7. The Court rejected this argument, stating that WCC's "surety right under subrogation amounts to a security interest in the monies earned and due and owing the contractor pursuant to the contract. It does not give rise to an assignment of the contractor's legal status under the contract." *Id.* at 460. In addition, the Court held that any attempt by Intercargo to so extend its subrogation rights was irrelevant since WCC had forfeited any rights to termination costs it may have had when it settled its claim with the government. *Id.*

Finally, Intercargo asserted that "fairness and equity" require that the government reimburse it. *Id.* at 461. However, the Court was not persuaded by Intercargo's plea to equity noting that:

[Intercargo] ignores the fact the government never received the materials at the

job site or otherwise and thus received no benefit at all. . . [Intercargo's] bond premium takes into account, or should do so, the risks that the contractor might default early and that as a result the surety might have to absorb a loss on the bond arrangement. While the doctrine of equitable subrogation lessens some of the surety's risks in writing its bonds, the government should not be considered an insurer of all plaintiff's risks.

8. Mendelsohn v. Dormitory Authority of the State of New York
(In re: QC Piping Installations, Inc.), 225 B.R. 553 (Bankr. E.D.N.Y. 1998)

Mendelsohn v. Dormitory Authority of the State of New York (In re: QC Piping Installations, Inc.), 225 B.R. 553 (Bankr. E.D.N.Y. 1998) the Bankruptcy Trustee for the Eastern District of New York challenged a surety's rights to retainage withheld by an owner, arguing that it should be part of the debtor contractor's bankruptcy estate. The Court granted the surety's motion for summary judgment, and based upon the principles of equitable subrogation, found that the retainage belonged to the surety. The Court addressed the question of whether *Pearlman* had survived enactment of the Bankruptcy Code and concluded after a lengthy analysis of cases applying the *Pearlman* doctrine, that the holding in *Pearlman* was still viable post-enactment.

In May 1991, the Dormitory Authority of the State of New York ("DASNY") awarded a construction contract to QC Piping Installations, Inc. ("QC"). 225 B.R. at 555. International Fidelity Insurance Company ("IFIC") issued performance and payment bonds to QC in connection with the project. *Id.* The contract between DASNY and QC included signed documents stating the contract price and completion date, and requiring that the work be performed in accordance with attached specifications and drawings. *Id.* at 555. The contract also referenced "contract documents," but did not specifically define the term. *Id.*

IFIC argued, and the Court ultimately concluded, that the "contract documents" included a document entitled "General Conditions for City University Projects" ("General Conditions"), which had not been executed by either party. *Id.* at 556. The General Conditions included a provision enabling the owner to retain from progress payments sufficient funds to ensure payment to laborers and materialmen and to protect the owner from loss due to defective work. *Id.*

After QC began performance of the contract, DASNY held back as retainage, five percent of the payments to QC. *Id.* In May 1993, QC defaulted and DASNY terminated the contract. *Id.* IFIC completed the construction and paid the claims of QC's laborers and materialmen pursuant to its bond obligations. *Id.* IFIC paid out more than \$660,000 in fulfilling its bond obligations. *Id.* at 557. At the time the contract was terminated, DASNY had withheld more than \$42,000 as retainage. *Id.*

After QC filed for Chapter 7 bankruptcy relief in June 1993, the Trustee filed an adversary proceeding against DASNY and IFIC, seeking to recover the retainage held by DASNY as part of the bankruptcy estate. *Id.* The Trustee claimed that IFIC and DASNY were indebted to QC in an amount not less than the retainage amount and that the retainage was property of the debtor pursuant to section 542 of the Bankruptcy Code. *Id.*

Finally, the Trustee claimed that the retainage amount constituted a preferential transfer voidable by the Trustee. *Id.* The IFIC argued that under the General Conditions, DASNY had the right to retain a portion of the progress payments, and that, under principles of equitable subrogation, it (IFIC) had rights to the retainage exclusive of QC. *Id.* Both the Trustee and IFIC moved for summary judgment. *Id.*

After determining that the General Conditions were part of the contract and that IFIC assumed all of DASNY's rights under principles of equitable subrogation when it (IFIC) undertook its bond obligations, the Court discussed the effect of the doctrine upon the rights of the parties. *Id.* The court determined that it is irrefutable under New York law that "a surety, after satisfying its obligations under either a performance or payment bond, is subrogated to the rights of the party he paid." *Id.* at 562. The court then recognized that the Pearlman holding squarely placed the interest in the retainage in IFIC.

However, because *Pearlman* was decided before enactment of the Bankruptcy Code, the court had to determine whether its holding survived passage of Section 541 of the Code. *Id.* at 564. Section 541 provides that the commencement of a bankruptcy case creates an estate, which is comprised of all legal or equitable interests of the debtor in property as of the commencement of the case wherever located and by whomever held. *Id.* Furthermore, the code provides that the nature and extent of the debtor's interest in property is to be determined by applicable non-bankruptcy law." *Id.*

The Court proceeded to analyze the myriad of cases in which the *Pearlman* doctrine had been applied post-enactment before finally concluding that the holding in *Pearlman* was still viable. It cited and discussed *In Re Modular Structures* in support of the proposition that *Pearlman* was still viable. *Id.* at 564-71. In so concluding, the Court held that the retainage was not, and had never been property of the bankruptcy estate. *Id.*

9. Kentucky Central Ins. Corp. v. Brown (In re: Larbar Corp.)
177 F.3d 439 (6th Cir. 1999)

The Sixth Circuit Court of Appeals recently addressed the rights of a surety when the principal contractor enters bankruptcy. *In re: Larbar*, 177 F.3d 439 (6th Cir. 1999). Specifically, the court addressed the surety's rights under the doctrine of equitable subrogation to balances due under the contract between the obligee and the debtor/contractor and the right of the surety to retain profits from one bonded construction project to offset the losses incurred by the surety in relation to other bonded projects. *Id.*

Larbar Corporation ("Larbar") entered into twenty nine (29) government contracts to erect guardrails at highway construction sites in Kentucky from January 1990 to October 1991. *Id.* at 442. Kentucky Central Insurance Company ("KCIC") provided performance and payment bonds on behalf of Larbar securing performance and payment relative to the contracts. *Id.* at 442. Larbar executed an Agreement of Indemnity applicable to any bonds issued by KCIC on behalf of Larbar. *Id.* The terms of the Agreement of Indemnity required Larbar to assign to KCIC all its rights under any contract on which Larbar abandoned its obligations. *Id.*

To finance the performance of the contracts, Larbar obtained a loan from the Bank

of Lexington & Trust Company (“Bank”) on May 25, 1990. *Id.* Bank was granted a security interest in Larbar’s accounts receivable from a project in Harlan County, Kentucky with Incisa USA, Inc. (“Incisa project”). *Id.*

In March of 1993, Larbar notified KCIC that it was unable to complete thirteen (13) of the construction contracts upon which KCIC had issued payment and performance bonds. *Id.* KCIC assumed responsibility for these projects. *Id.* Two weeks later, Larbar filed Bankruptcy. *Id.* KCIC petitioned the court and obtained an order of abandonment of the contracts assumed by KCIC. *Id.* KCIC completed work on the projects with substantial losses on most of the contracts. *Id.* KCIC realized a \$24,944.89 net profit on the Incisa project. *Id.* at 443.

The trustee filed a complaint seeking to avoid KCIC’s security interest created by the Agreement of Indemnity. *Id.* KCIC responded that, regardless of the status of its security interest, it was entitled to the receivables under the doctrine of equitable subrogation or pursuant to a trust fund theory and that it had the right to set off the net profits gained on some projects against the net losses incurred in the completion of others. *Id.*

Prior case law in the federal Sixth Circuit did not provide a comfortable basis for KCIC’s posture. In *Indiana Lumbermens Mutual Insurance Company, Inc. v. Construction Alternatives, Inc. (In re: Construction Alternatives, Inc.)*, 2 F.3d 670 (6th Cir. 1993), Lumbermens sought to obtain the final proceeds from the debtor’s bonded contract relative to which it had made payments to subcontractors of the debtor pursuant to its payment bond. *Id.* at 673-74. Lumbermens asserted that its right to the proceeds was superior to the tax lien of the Internal Revenue Service (IRS) because it had a lien on the funds based upon the doctrine of equitable subrogation. *Id.* at 675-76. The court held that Lumbermens merely stepped into the shoes of the unsecured subcontractors and had no right to the funds which would defeat the IRS lien. *Id.* at 676. The court further noted that, even if Lumbermens did have an equitable lien, it was not perfected before the IRS lien attached because Lumbermens’ lien was not “certain” as to amount at the time the tax lien arose. *Id.* Under similar facts and circumstances, the Bankruptcy Court for the Western District of Ohio followed the Sixth Circuit’s decision in *Construction Alternatives* and denied USF&G’s claim to final payment on a bonded contract holding that the payment is property of the bankruptcy estate to the detriment of the surety’s equitable claim to said funds. *Slutsky v. Cincinnati (In re: Wm. Cargile Contractor, Inc.)*, 203 B.R. 644 (Bankr. W.D. Ohio 1996).

Similarly, the Bankruptcy Court for the Middle District of Tennessee denied Great American Insurance Company’s (Great American) attempt to assert the doctrine of equitable subrogation to obtain progress payments from a bonded contract on which Great American had satisfied claims of subcontractors pursuant to its surety bond. *Great American Insurance Company v. Universal Builders, Inc. (In re: Universal Builders, Inc.)*, 53 B.R. 183 (Bankr. M.D. Tenn. 1985). The court based its determination that the debtor-in-possession had superior rights to the progress payments on the distinction between retainage and progress payments. *Id.* at 186. While the court recognized that a surety may have an equitable lien on funds retained by the owner of the project to secure payment of subcontractors, it distinguished progress payments as “essential to provide working

capital for a contractor.” *Id.* Therefore, the court ordered that the progress payments be paid to the debtor as part of the bankruptcy estate over the equitable claim of the surety. *Id.*

Equitable Subrogation

The doctrine of equitable subrogation arises when a contractor defaults on its obligations and a surety completes the work called for by the contract and pays all the related bills. *Id.* The Supreme Court, in *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 141 (1962), established a surety’s right to payment due the contractor when the surety completes the defaulted contractor’s obligations. This right arises whether the bond is for payment or performance. *Id.* at 139; *In re: Larbar* at 443. The right of subrogation relates back to the date of the issuance of the bonds. *In re: Larbar*, at 443-44.

The *Larbar* court held that the surety’s right of equitable subrogation takes precedence over any subsequently acquired security interest, and, therefore, the Bank’s interest. *Id.* at 444. Therefore, the court determined that KCIC, through the application of the doctrine of equitable subrogation, obtained rights to the proceeds earned on various Larbar projects superior to those of the Bank and the trustee in bankruptcy. *Id.*

B. Setoff

Considering the doctrine of equitable subrogation allows the surety only to retain contract balances to the extent necessary to recover the losses relative to the contract, the surety does not obtain rights, through the doctrine of equitable subrogation, to profits on the project. Therefore, KCIC sought to offset its losses on certain contracts with profits from other contracts. Two sets of contracts were at issue. *Id.* at 445. Larbar entered into numerous contracts directly with Kentucky with a total net loss in excess of \$139,000. Five contracts generated a net profit of \$3,107.47. *Id.* Larbar entered into two contracts with Incisa. *Id.* One of the Incisa contracts yielded a profit of \$24,944.89 and the other was a net loss of \$18,829.31. *Id.* Pursuant to § 553 of the Bankruptcy Code “a creditor can offset its losses against its profits when the creditor and debtor have mutual, pre-petition obligations.” 11 U.S.C. § 553; *Larbar*, at 445. In order to offset its losses, the creditor must establish mutuality between it and the debtor, the debts must be prepetition debts, and the court has equitable discretion to deny the setoff if it would prejudice other third-party creditors. *Id.* at 445-47.

Because KCIC’s payments discharged the debts of Larbar, it is “entitled to step into the shoes of the creditor and assert the creditor’s rights of setoff against the debtor in order to recover payments that the surety has made.” *Id.* at 446. Therefore, KCIC was able to establish mutuality with respect to both sets of contracts at issue. Both the obligations between the creditors and Larbar and the obligations between Larbar and KCIC (which arose on the date of the issuance of the bonds) arose prepetition, therefore, the second part of § 553 is satisfied. *Id.* Finally, as the surety satisfied Larbar’s obligations to subcontractors and contractors, the remaining creditors are general creditors of the estate. Therefore, no third party creditor would be prejudiced by the application of § 553’s right to setoff.

Based upon the above analysis, the court determined that the profits and losses from the Incisa projects may be setoff by one another and the net gain be remitted as property of the estate. *Id.* at 447. Similarly, the net profits on the two Kentucky projects would be used to offset the net loss relative to other Kentucky projects. *Id.* In dicta, the court noted the policy considerations weigh in favor of the surety:

A surety is obligated to complete any remaining contracts after its principal defaults. If, however, it is denied the right of setoff, then the surety might be tempted to "cut corners" rather than promptly and properly complete the losing contracts. The opportunity to setoff any profits against its losses on multiple-bonded projects thus serves as a practical incentive for the surety to fulfill all its obligations....Granting a setoff in such a case, therefore, is not only permissible but desirable to further the policy considerations underlying § 553.

Id.

Without mention of other decisions within the Sixth Circuit to the contrary, the *Larbar* court dispositively established the surety's right of equitable subrogation to retain both progress payments and retainage from contracts upon which the contractor defaults and the surety completes its obligations. In addition, the court held that the surety can also take profits from one or more bonded projects to offset losses on other bonded projects so long as the profits and losses both arose before the bankruptcy petition and involve contracts between the same parties. This decision represents a subtle, but fundamental, change in the status of bankruptcy law in the Sixth Circuit.

III.

Lessons Learned: Seven Myths about Equitable Subrogation

Myth #1. The Surety's subrogation rights reach retention only.

We have heard much over the years of the labored distinction between "earned but unpaid progress payments" and "retention." The theory, most notoriously asserted by bankruptcy courts to divest the surety of ongoing progress payments, is that the surety's equitable subrogation rights reach retention only. The "earned but unpaid progress payments" of a Chapter 11 debtor may be used for the estate's general purposes, on this theory. This approach appears to be occasioned by a narrow reading of *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 83 S. Ct. 232, 9 L.Ed.2d 190 (1962).

This approach may serve the interest of both the principal in Chapter 11 and its secured creditor bank. First, the surety's interest is limited to the retained fund. Second, the so-called "earned but unpaid progress payments" become the subject of a conventional cash collateral order in the Chapter 11 proceeding, a device with which both debtor and bank counsel are comfortable. The theory is supported by the remarkable and frequently unprovable supposition that the progress payments at issue have been "earned." As further discussed in our consideration of Myth #5, this approach may well be rooted in a failure to understand the surety's subrogation to the set off rights of the project owner.

Stated differently, this theory appears to be rooted in the mistaken belief that a progress payment can be "earned" when the bills associated with the payment request have not been paid.

Fortunately, the matter has been capably laid to rest by decisions such as *Modular Structures* and *Larbar*. As noted by the *Larbar* Court, "the law is clear that a surety under these circumstances has a right to the payments due the contractor to the extent of full reimbursement." *Kentucky Central Ins. Corp. v. Brown (In re: Larbar Corp.)* 177 F.3d 439 (6th Cir. 1999); see also *Mendelsohn v. Dormitory Authority of the State of New York (In re: QC Piping Installations, Inc.)*, 225 B.R. 553, 564 (Bankr. E.D.N.Y. 1998)

Myth #2. Bank lawyers do not understand equitable subrogation.

Who among us has not seen the incredulous looks when we advance the obviously dicey proposition that the surety, and not the secured creditor bank, is entitled to the defaulting principal's contract balances? Bank special assets personnel and their counsel normally greet this assertion with incredulity, but only if in a good mood. Outright derision is not uncommon. After all, does not Article 9 of the Uniform Commercial Code establish an understandable, coherent system for the public perfection of a security interest? Is not equitable subrogation nothing less than a "hidden lien" which is clearly not a favorite of the law?

Do not believe it. It would be a safe wager than construction lenders are taught about the surety's role and its priorities in bank school and in-house seminars. Wagers aside, the banking industry evinces a rather good understanding of equitable subrogation when the doctrine says the *bank* gets the money.

Instructive on this point would be a recent article entitled "The Equitable Subrogee vs. The Bankruptcy Trustee: New Uses for an Old Doctrine," 1997 ABI JNL LEXIS 125(Feb. 1997). There, the authors note:

Subrogation has been applied to permit a current lender to step into the shoes of a prior lender and to exercise all of the rights and powers that the prior lender enjoyed, even where the current lender clearly failed to adhere to the requirements of the Uniform Commercial Code or state recording acts for perfecting the current lender's own security interest.

After a review of secondary and decisional authorities which support the proposition that unperfected "Bank B" may be equitably subrogated to the security documentation of perfected "Bank A", the authors conclude as follows:

While its use may at first appear a bit shocking, subrogation can be a very powerful tool in circumstances where a refinancing lender experiences the nightmare of not being perfected because the right documents were not filed in the right place. Depending upon the facts and circumstances of the case, the current lender may be subrogated to the rights of a properly perfected prior lender and defect the avoiding powers of the bankruptcy trustee, turning the nightmare into just a dream.

Myth #3. Only direct obligations of the Surety under its Payment and Performance Bonds are covered by equitable subrogation.

We have been taught that the surety's equitable subrogation rights reach only contract funds on the particular project upon which it has paid claims for labor or materials or otherwise performed its direct obligations as surety pursuant to its performance and payment bonds. But, a surety may make a business decision to pay certain unsecured claims or provide financial assistance to a principal outside the strict limitations of its bonds. Such a business decision may ultimately prove to be a good one, but no subrogation rights are thought to arise by reason of such "soft" expenditures.

The *Bank One* Court reaches a different conclusion in what, unfortunately, is a decision not designated for publication. But while Rule 47.7 of the Texas Rules of Appellate Procedure prohibits citation of an unpublished opinion and gives same "no precedential value", there is no prohibition on citation of the opinion here. Moreover, whether the opinion may be cited or not, the inescapable fact is that the surety won the case.

The *Bank One* decision is a useful guide on how sureties and their counsel may aggressively seek to expand their equitable subrogation rights to cover expenditures other than those directly required by the bonds. Because of this decision, we know of at least one trial and appellate court which agree that subrogation rights may be expanded by reason of payments other than those most directly connected with bond obligations.

Myth #4. The Surety may safely rely on its equitable subrogation rights without other means of protecting its interests.

If anything should be clear from Section II of this paper, it should be that there are no shortage of parties anxious to deprive the performing surety of bonded contract balances. Whether in concert or independently, the surety faces competing claims of the principal or debtor in possession; unsecured creditors; bankruptcy trustees; and secured lenders. Given the competition for the available funds, therefore, it seems only sensible to erect every possible barrier for the protection of the surety's interest in contract proceeds.

The financing surety is obviously in the best position to document and perfect its claim to contract proceeds on a variety of grounds. A pre-default Indemnity Agreement will obviously contain trust fund provisions and the grant of an unperfected security interest in contract proceeds. State statutes may benefit the surety through the imposition of trust obligations which mandate the payment of project claimants. This array of protections, together with equitable subrogation, is not always sufficient to thwart the claims of competing creditors to contract proceeds.

When financial assistance is extended, the surety has an excellent opportunity to seek further, contractual protections. These additional protections may include more expansive trust language; perfection of the security interest granted by the Indemnity Agreement (sometimes supplemented by separate security documentation); and the establishment of further protective devices such as trust, joint control, and cash collateral accounts.

Myth #5. The Surety is subrogated to the rights of payment bond claimants only.

The surety's subrogation to the rights of claimants, the principal, and the obligee is obviously far from clear to many, as evidenced by the numerous bankruptcy court decisions which appear to understand the surety as being subrogated to the rights of project claimants only. Emblematic of this approach is the decision in *Universal Builders*: project creditors are merely unsecured, general creditors of the estate, and the resulting rights of the performing surety are those of an unsecured, general creditor. While the *Construction Alternatives* Court made an attempt to consider subrogation to the right of a broader range of parties, at its core this decision is dismissive of this approach and looks primarily to the rights of project creditors in determining the performing surety's resulting rights.

Fortunately, well thought out decisions of the Third (*Modular Structures*) and Sixth (*Larbar*) Circuits lay this theory to rest.

Myth #6. Equitable subrogation is a creature of equity only and not of contract.

It is axiomatic that the subrogation rights of the surety are a creature of equity and not of contract. Not quite always. Passively accepting this proposition means that sureties and their counsel may miss opportunities to protect and expand their subrogation rights. These opportunities occur most clearly in the context of manuscripted indemnity agreements; default and financing documentation; and intercreditor agreements with secured lenders and other involved parties.

When an Indemnity Agreement is being specially manuscripted, the surety has an excellent opportunity to obtain an express acknowledgment of its equitable subrogation rights from the principal and indemnitors. Presumably competitive forces in current surety credit markets result in fewer manuscripted indemnity arrangements. Presumably the circumstances of these credit markets will someday change yet again, and sureties and their counsel should keep in mind the opportunity to obtain an express acknowledgment of equitable subrogation rights.

Whatever the status of the surety credit markets, there will always be defaulting principals and sometimes there will be circumstances where financial assistance is determined to be appropriate. Again, an express acknowledgment by the principal and indemnitors of the surety's subrogation rights is useful. The same is no less true in multi-party arrangements such as Intercreditor Agreements.

The acknowledgment of the surety's rights can be simple or complex. Whatever the form of such acknowledgment, however, the language effecting the acknowledgment should be a straight-forward, unambiguous statement of the performing surety's right to contract proceeds by reason of equitable subrogation

Myth #7. The Sixth Circuit is a hostile environment for assertion of the Surety's equitable subrogation rights.

We previously characterized the *Larbar* decision as representing a subtle but

fundamental change in the status of bankruptcy law in the Sixth Circuit. Before the *Larbar* decision, it was axiomatic that the Sixth Circuit was a hostile environment for assertion of the surety's equitable subrogation rights. Such a conclusion was not unwarranted, given the trial and appellate decisions in *Universal Builders* and *Construction Alternatives*, respectively.

Even prior to *Larbar*, however, there were grounds for optimism. First, substantive state law was and continues to be favorable to the surety in the individual states within the Circuit. Moreover, *Construction Alternatives* can be credibly characterized as an aberration: the Court's ruling on setoff is inconsistent with other Sixth Circuit decisions, and the disregard of AIA and common law set off provisions can only be characterized as reflecting unfortunately on the Court's decision. At the simplest level, *Construction Alternatives* can be distinguished away by showing that a right of set off exists.

At the time of its appearance in 1985, the *Universal Builders* decision was greeted with dismay and much unfavorable commentary within the surety industry. However, even this adverse opinion contains hope for the surety. As the court noted, "no misapplication [of contract funds] or mismanagement has been shown. Evidence of this type, if it exists, would be relevant should the Plaintiffs seek a remedy such as the appointment of a Trustee..." *In re: Universal Builders, Inc.*, 53 B.R. at 187.

Whatever the reading of the decisions in *Universal Builders* and *Construction Alternatives*, with *Larbar* it can now be said that this Circuit is a most favorable forum for the assertion of the surety's equitable subrogation rights.

IV.

Conclusion

Clearly, the case law trends are operating in favor of the surety. Decisions in the Third and Sixth Circuits have come down squarely in favor of the surety's right of equitable subrogation. Even where the surety receives an adverse result, such as the Ninth Circuit, the Court appears clearly troubled by the outcome.

The myths associated with the doctrine of equitable subrogation, of which we have considered only seven, appear to be fading. Favorable judicial decisions have solidified the basis and scope of the surety's equitable subrogation rights, and it would appear that there are now opportunities to assert an expansion of those rights.

Notwithstanding the more favorable judicial environment, however, sureties should be vigilant to protect their interests in contract proceeds by all available means, relying not just on legal theory but contractual protections as well.