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PRACTICAL POINTERS ON PREFERENCES

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THE CONCEPT OF PREFERENCES

One primary policy of the Bankruptcy Code is to promote some degree of equality of rights among creditors of similar status, all of whom have competing claims on the insufficient assets of the debtor. A debtor's payment of debts owed to some creditors but not others just as bankruptcy is looming will undermine and evade this goal of equal treatment within classes of creditors. Thus, the trustee (or, more often these days, the debtor in possession) is given the power to avoid certain pre-bankruptcy payments to creditors on the ground that they are "preferences," and to recover the payments for orderly, pro-rata distribution among all creditors.

Preference claims pose a significant challenge for a surety. An insolvent general contractor often pays the "squeakiest wheels" on long past-due accounts shortly before filing bankruptcy. Those subcontractors and suppliers of the bankrupt contractor can suddenly find themselves "unpaid," when the debtor takes back payments the contractor made within 90 days of filing a bankruptcy petition. Luckily for those subs, unluckily for the surety, there sits the payment bond as a target to replace the lost payments. This is not a promising scenario for the surety, who soon may be left with a hollow right of indemnification. Fortunately, the Bankruptcy Code provides a variety of defenses that can keep money the principal paid to subs in those subs' hands.

THE ELEMENTS OF AN AVOIDABLE PREFERENCE

Under the preference rules of the Bankruptcy Code, unless the transfer of a debtor's property interest satisfies one of the statutory exceptions to the preference rule discussed below, the debtor may avoid that transfer if it:

- (1) was to or for the benefit of a creditor;
- (2) was for or on account of an antecedent debt owed by the debtor before the transfer was made;
- (3) was made while the debtor was insolvent;
- (4) was made on or within 90 days before the date of the filing of the debtor's bankruptcy petition, or, if the creditor was an insider¹ at the time of the transfer (e.g., an officer, director,

¹ An "insider" is "one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor." The consideration of (This note continued on following page)

shareholder of closely-held corporation), within one year before the date of the filing of the petition;² and

- (5) enables the creditor to receive more than the creditor would receive if the case were under Chapter 7, the transfer had not been made, and payments were made as provided by the Bankruptcy Code.³

All five of these elements must be shown or the preference is not avoidable, and the debtor has the burden of proving these elements. In analyzing whether a transaction is a preference, the courts focus on the effect of the transaction (namely, to diminish the size of the estate available for distribution in payment of claims), rather than the intent or motive of the debtor or creditor.

Since the intent or motive of the debtor or creditor is not a material factor in determining whether a transfer is a preference, a preference is distinguishable from a fraudulent transfer, which is “inherently and always vicious,”⁴ because its goal is to place the assets of the debtor beyond the reach of its creditors.⁵ Moreover, a preference is valid unless made within the prohibited period (90 days prepetition for an outsider creditor, one year for an insider), while a fraudulent conveyance is void regardless of its date, by very reason of the ill motive involved.⁶

COMMON PREFERENCE SCENARIOS IN THE SURETY CONTEXT

Situations giving rise to preference claims which impact the surety either directly or indirectly are not difficult to envision, nor are the dangers of the surety’s multiple exposure which loom behind the law of preference.

A very unfortunate scenario could arise where the surety advances “look-see” money requested on short notice by a principal. Absent the surety’s careful planning

insider status focuses on two factors: (1) the closeness of the relationship between the parties; and (2) whether the transaction was negotiated at arm’s length.” 5 COLLIER ON BANKRUPTCY ¶ 547.03[6] (2003).

² Many in the surety community are familiar with the *Deprizio* decision, in which the U.S. 7th Circuit Court of Appeals greatly expanded the reachback period for certain transfers, by holding that transfers to *non-insider creditors* that benefit *insider guarantors* were voidable for the same one-year period as direct transfers to insiders. *Levit v. Ingersoll Rand Financial Corp. (In re Deprizio Constr. Co.)*, 874 F.2d 1186 (7th Cir. 1989). This scenario is common in the surety relationship, where the principal’s payments to subs relieve indemnitors (who are typically insiders) of the duty to indemnify the surety to the extent of the payments. The Bankruptcy Reform Act of 1994 overruled the *Deprizio* line of cases insofar as they were onerous to sureties, by declaring that non-insider transferees are not subject to preference claims beyond the 90-day statutory period, even for preferential transfers benefiting insiders. However, “[such] transfers remain avoidable with respect to the insiders who benefitted from them.” 5 COLLIER ON BANKRUPTCY ¶ 547.03[6].

³ 11 U.S.C. § 547(b).

⁴ 9B AM. JUR. 2D. *Bankruptcy* § 1888 (2004).

⁵ 5 COLLIER ON BANKRUPTCY ¶ 547.01 (2003).

⁶ 9B AM. JUR. 2D. *Bankruptcy* § 1888 (2004).

and proper understanding of the defenses to preference actions, the surety could find itself paying a sub twice. We all know the scenario: To keep a project on track where the principal is ailing, the surety may pump money into the project. The principal, using the surety's money, is paying subs for work on Project, most likely the noisiest subs. Somewhere down this path, the principal files for bankruptcy, and as debtor in possession then files preference actions to reclaim those funds paid to subs within 90 days before the bankruptcy petition was filed. When the debtor prevails and recovers those funds for the bankruptcy estate, the losing subs now find themselves unpaid once again, and make claims against the payment bond. Suddenly, the surety may find itself called upon to pay subs under the payment bond, who were already paid once before with the surety's money given to the principal.

More intriguingly, in the absence of a viable defense such as those listed in the following section, a bankrupt principal has several avenues for filing a preference action against its own surety. Indeed, the trustee/debtor has a fiduciary duty to the other creditors to sue the surety where the elements of a preference exist.

For instance, where the principal makes a payment to a sub within 90 days of filing bankruptcy, and that payment is indeed a preference, then under the Bankruptcy Code the surety has also received a preference. This is true even though the surety did not directly receive any payment. Bankruptcy law may result in a holding that payments to subs on the bonded project benefit the surety by relieving the surety of its obligation under the bond to pay those debts. So long as the other elements of a preference under Section 547 are satisfied, these payments are "indirect preferences" to the surety that may be recovered from the surety as if the surety had received direct payment.⁷

Another situation in which the principal may file a preference action against the surety is where the surety obtains collateral from the principal. The grant of a security interest such as a mortgage on property is a "transfer" in favor of the surety, and thus may be scrutinized should it occur within 90 days before the principal files bankruptcy. Indeed, where "insiders" of the principal have given indemnity to the surety, the principal's transfer of collateral to the surety within one year of the principal's bankruptcy may subject those insiders to a preference claim, since the transfer of collateral benefits the insiders by reducing their indemnity debt.

⁷ See, e.g., *Newbery Corp. v. Fireman's Fund Ins. Co.*, 106 B.R. 186, 187 (D.Ariz. 1989). The court in *Newbery Corp.* summarized an action for "indirect preference" as follows: "[Surety] is a creditor of the estate because it holds a contingent claim upon the estate for any amounts it may have to pay on its bonds. 11 U.S.C. § 101(9); 4 Collier on Bankruptcy, § 547.04.[1] (15th ed. 1989). Therefore, to the extent [Principal] paid debts that [Surety] would otherwise have had to pay, [Surety] received an indirect preference. [Principal's] theory is based on a bankruptcy maxim that the estate may proceed directly against a surety, instead of circuitously recouping the preference from the creditor, forcing the creditor to proceed against the surety and then waiting for the surety to assert a claim against the estate for reimbursement. See 4 Collier, supra n. 5 (and cases cited therein)."

DEFENSES TO PREFERENCES COMMON IN THE SURETY CONTEXT

There are two main categories of defenses to preference claims: (1) statutorily-recognized defenses or exceptions to otherwise avoidable preferences, and (2) grounds for asserting that a transfer was not a preference in the first place.

In the first category, the Bankruptcy Code in 11 USCA § 547(c) sets forth exceptions which, if applicable, preclude the trustee from avoiding a preferential transfer, including:

- (1) contemporaneous exchanges for new value given to the debtor;
- (2) payments of debts incurred by the debtor in the ordinary course of business;
- (3) transfers creating purchase money security interests securing new value;
- (4) transfers to creditors who then give new value to the debtor;
- (5) certain transfers creating perfected security interests in inventory or receivables; and,
- (6) transfers that fix certain statutory liens; and

Some of these defenses may protect a greater portion of a scrutinized transfer than others, so as always it is wise to raise as many of the defenses as arguably apply in response to a preference claim, to maximize the potential protection of the payment sought to be recovered.

Several of these statutory defenses have clear and unique application to preference actions arising in the construction surety context:

- **Payments Made in the Ordinary Course of Business**

Not every payment made within 90 days of the contractor's filing bankruptcy is automatically subject to a preference claim. As the name implies, a "preference" is a payment that favors a particular creditor over others because it is made under circumstances in which it would not normally have been made. Thus, payments made in the ordinary course of business (the most typical of these are the "monthly bills" such as rent and utilities) are not avoidable preferences.⁸

⁸ "[T]he legislative history of 11 U.S.C. § 547(c)(2) [the "ordinary course of business" exception] ... indicates that the purpose of the subsection 'is to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy.' Sen.Rep. No. 95-989, 95th Cong., 2d Sess. 88 (1978), U.S.Code Cong. & Admin.News 1978, pp. 5787, 5874." *In re Alter-Hall Const. Co., Inc.*, 73 B.R. 989, 992 -993 (Bkrtcy. D.Mass., 1987).

Where a sub can demonstrate that it was the bankrupt contractor's standard practice to pay subs 60 days after the work or after invoice, it may be able to defeat a preference claim asserted as to such a payment made within 90 days of the contractor's bankruptcy petition, as having been made in the ordinary course of business. Ironically, this means a sub may get to keep money paid during the preference period, when a chronically late-paying principal simply follows his typical practice and makes a debt payment which under other circumstances would appear to have been made on a past due account under the mounting pressure of approaching insolvency.

In terms of the Bankruptcy Code, the rule is that the debtor or trustee cannot avoid a transfer so far as it was: (1) in payment of a debt the debtor incurred in the ordinary course of both the debtor's and creditor's business, (2) made in the ordinary course of both the debtor's and creditor's business, and (3) made according to ordinary business terms.⁹

Most courts interpret this last element to require examination of the manner and timing of the payment in light of standard practices in the relevant industry, not just what is typical between the two parties or even between the debtor and all of its creditors generally.¹⁰ Given the prevailing practices in the construction industry, this last element would cut in favor of a sub getting to keep a payment "late" on paper but "on time" in practice.¹¹

Indeed, in analyzing what is the "ordinary course of business" of the parties and what are "ordinary business terms" pertaining to a specific payment under scrutiny, it is entirely relevant to look at factors such as the type of construction project, the identity and size of both the owner and the general contractor, and the relative size of the subcontractor. It is no secret that the some contractors in some trades may ride subs and impose the harshest payment terms on the smallest subs, which ironically may mean that some payments made to subs a very long time after the work was performed are not avoidable preferences, even though made within 90 days of the contractor's bankruptcy.

⁹ 11 U.S.C. § 547(c)(2).

¹⁰ See, e.g., *In re Fred Hawes Organization, Inc.*, 957 F.2d 239, 246 (6th Cir. 1992) ("[C]ourts do not look only at the manner in which one particular creditor interacted with other similarly situated debtors, but rather analyze whether the particular transaction in question comports with the standard conduct of business within the industry."). See also, Matthew M. Horowitz and M. Michael Egan, *Practical Implications of Bankruptcy on the Parties' Rights in a Construction Contract*, CONSTRUCTION LAWYER, Spring 2002, at 5.

¹¹ See, e.g., *In re ML & Associates, Inc.*, 301 B.R. 195 (Bkrcty. N.D.Tex. 2003) (Debtor-contractor's payment to subcontractor for work that it performed on construction project was made "according to ordinary business terms," as required for subcontractor to successfully assert "ordinary course of business" defense to trustee's preference claims under 11 U.S.C.A. § 547(c)(2)(C), where expert testimony presented by subcontractor showed that timing of payment, two or three days after debtor received payment from property owner, and terms on which payment was made, after subcontractor executed lien waiver, were consistent with those in construction industry).

- **Contemporaneous Exchange for New Value**

New value is added to the estate when an insolvent but bonded contractor pays a sub for a preexisting debt. This is because such payment by a bonded contractor extinguishes the surety's right of equitable subrogation over contract funds to the extent of the payment, and truly does free that amount to flow into the estate rather than to the surety. Otherwise, had the surety been forced to make the payment because the contractor did not, the surety's equitable subrogation rights over that amount of contract proceeds would have been superior even to the bankruptcy estate's claim on such proceeds.

Courts to have a greater or lesser degree accepted this logic as falling with the ambit of the statutory exception to preference actions for "contemporaneous exchanges for new value."¹² Under this exception, the Bankruptcy Code prohibits a trustee from avoiding a transfer to the extent it was intended by the debtor and creditor to be a contemporaneous exchange for new value given to the debtor, and was in fact substantially contemporaneous.¹³

Usually, the payment of a sub by a contractor comes with "contemporaneous exchange for new value" built right in, given how contractors and subs typically interact. For instance, when a contractor pays a sub some amount to induce the sub to return to the job and resume the work of the subcontract, the sub's return constitutes a waiver of the principal's standing breach of contract (i.e., its nonpayment of earned draws). The sub's waiver and release of lien rights flowing from the principal's breach are new value which the sub has substantially contemporaneously exchanged for payment by the principal. Similarly, even a sub paid immediately upon invoicing generally must sign a partial lien waiver up to the amount of the draws paid to that point, and this relinquishing of the sub's right to lien the property for work performed is new value contemporaneously exchanged with the principal to receive payment.

- **Subsequent Advance of New Value**

In the construction context, additional labor or materials may sometimes be extended on credit to the contractor only after the contractor makes a payment of amounts already due to that sub or supplier. When the contractor makes such a payment of existing debt during the preference period to induce the advancing of additional labor or materials to the project, such payment may not be avoidable as a preference.¹⁴ This is because the Bankruptcy Code prohibits a trustee from avoiding a

¹² See, e.g., *In re E.R. Fegert, Inc.*, 88 B.R. 258 (9th Cir. BAP, 1988) (Chapter 7 debtor's otherwise preferential payments to subcontractors, in exchange for subcontractors' release of their unsecured claims against debtor as well as their claims against surety, came within exception to preference for "new value" being given in substantially contemporaneous exchange, in that debtor's payments to subcontractors avoided imposition of equitable lien by surety on future payments under contract).

¹³ 11 U.S.C. § 547(c)(1).

¹⁴ See, e.g., *In re Trans-End Technology, Inc.*, 228 B.R. 181 (Bkrtcy. N.D. Ohio, 1998) (subcontractor named as defendant in preference proceeding brought by trustee of debtor-contractor's estate (This note continued on following page)

transfer so far as it was to or for the benefit of a creditor, and the creditor thereafter gave new value to or for the benefit of the debtor, which new value was not secured by an otherwise avoidable security interest and was not used by the debtor to make an otherwise unavoidable transfer to or for the benefit of that same creditor.¹⁵

- **Payment Made in Satisfaction of a Perfected Statutory Lien**

The Bankruptcy Code specifically prohibits a trustee/debtor from avoiding a transfer that is “the fixing of a statutory lien that is not avoidable under section 545” of the Code.¹⁶ In most states a perfected mechanic’s lien meets this definition, so the subcontractor’s release of a perfected lien upon receipt of the contractor’s payment during the preference period is often a defense to a preference claim. Logically, this defense is basically a specific application of the contemporaneous exchange for new value exception.

Turning now to the second category of preference defenses, grounds for demonstrating that the scrutinized payment was not a preference because the money used to make the payment was never the debtor’s property, trust fund concepts and earmarking have important roles in the construction surety context:

- **Trust Fund**

When a contractor writes checks to subs, often state law (by statute, case law or application of governing contract terms) deems those funds to have been paid to the contractor in trust, for payment only to those subs whose work earned the contractor those funds. Since the contractor receives the funds in trust for certain others and does not have the discretion to use those funds for payment of any of its other creditors, bankruptcy courts may conclude that those funds were never actually the contractor’s property. In this situation, the bankruptcy estate has no claim to recover such funds, because the debtor cannot avoid a transfer of property that it never owned.

State law trust fund statutes,¹⁷ trusts arising under state common law (including a sub’s equitable lien over contract funds recognized in some states¹⁸), the indemnity

established elements of “subsequent new value” defense, by showing that subcontractor provided additional materials to debtor-contractor, after the date of debtor’s challenged payments, for which subcontractor was not paid).

¹⁵ 11 U.S.C. § 547(c)(4).

¹⁶ 11 U.S.C. § 547(c)(6).

¹⁷ See, e.g., *In re Dunwell Heating & Air Conditioning Contractors Corp.*, 78 B.R. 667 (Bkrcty. E.D.N.Y., 1987) (New York Lien Law, which provides that funds received by owner or contractor in connection with contract for improvement of real property or for public improvement constitute assets of a trust, was applicable to accounts receivable paid for work performed or materials supplied by debtor’s subcontractors or materialmen, where debtor was in business of constructing heating and air conditioning systems and employed contractors, materialmen, and suppliers).

¹⁸ See, e.g., *DeKalb County v. J & A Pipeline Co., Inc.*, 263 Ga. 645, 437 S.E.2d 327 (1993) (recognizing that under Georgia statutory regime requiring payment bonds on public projects, and in light of mechanics’ lien statutes and terms of contract between owner and general contractor, an equitable lien in (This note continued on following page)

agreement behind the bond,¹⁹ and sometimes the bonded contract itself²⁰ – all of these are sources which may individually or in conjunction with the others impose a trust on funds paid to the contractor. Because the existence of a trust is a question of state law, and because property held by the debtor under a valid trust is excluded from the debtor's estate, bankruptcy courts have recognized and enforced these statutory and contractual trusts imposed on money paid to contractors.²¹

Where the surety intervenes with a troubled principal before bankruptcy, the financing agreement typically will be drafted deliberately to satisfy whatever requirements arise under state law for the express creation of a trust upon funds, thereby ensuring funds used to pay subs cannot ever be characterized as property of the estate and will be protected from preference claims.²²

A typical trust fund provision in an indemnity agreement might read as follows:

Principal and indemnitors herein agree and hereby expressly declare that all funds due or to become due under any contract covered by a Bond are trust funds, whether in the possession of Principal or another, for the benefit of payment of all persons to whom Principal incurs obligations in the performance of such contract for which Surety would be liable under

favor of unpaid subs arises to the extent that the public entity owner holds funds earned on the general contract but not yet paid to the general contractor).

¹⁹ See, e.g., *Matter of Jenkins*, 110 B.R. 74, 76 (Bkrcty. M.D.Fla., 1990) (Court found that General Indemnity Agreement between surety and contractor created the fiduciary relationship of a trust, because the language set up the trust, established a trust corpus, and showed an intent by the parties to create a fiduciary relationship); *In re Alcon Demolition, Inc.*, 204 B.R. 440 (Bkrcty. D.N.J., 1997) (Indemnity agreement between Chapter 11 debtor and its surety created enforceable trust under New Jersey law where agreement stated that trust was to be created, that trust res was to consist of all monies due or to become due for any bonded contracts on which surety must perform, that materialmen and laborers, along with surety in case of payment under the bonds, were trust beneficiaries, and that debtor was trustee.).

²⁰ See, e.g., *Federal Ins. Co. v. Fifth Third Bank*, 867 F.2d 330 (6th Cir. 1989) (Contract which referred to state's progress payments to general contractor as funds in trust created express trust under Ohio law with state as settlor, general contractor as trustee, and job creditors as beneficiaries, even though contract did not require general contractor to hold money in separate account.); *In re Gonzales*, 22 B.R. 58 (9th Cir. BAP, 1982) (Where each subcontract provided that all money received by the subcontractor from general contractor immediately became and constituted a trust fund for the benefit of "persons and firms supplying labor (and) materials ... for the benefit of said persons and firms, and shall not in any instance be diverted by Subcontractor to any other purpose until all obligations arising hereunder have been fully discharged and all claims arising therefrom have been fully paid," court found valid trust fund created).

²¹ See cases cited above in notes 17-20.

²² Note that the requirements of state law for express creation of a trust are typically very simple. In Georgia, for instance, the statutory requirements for the creation of an express trust are that it must be "created or declared in writing," and the following elements must be present and "ascertainable with reasonable certainty: (1) An intention by a settlor to create a trust; (2) Trust property; (3) A beneficiary; (4) A trustee; and (5) Active duties imposed on the trustee, which duties may be specified in the writing or implied by law." O.C.G.A. § 53-12-20. Under Georgia law, "[n]o formal words are necessary to create an express trust." O.C.G.A. § 53-12-21.

the Bond. If Surety discharges any such obligation it shall be entitled to assert the claim of such person to the trust funds. Principal shall, upon demand of Surety and in implementation of the trust or trusts hereby created, open an account or accounts with a bank or similar depository designated by Principal and approved by Surety, which account or accounts shall be designated as a trust account or accounts for the deposit of such trust funds, and shall deposit therein all monies received pursuant to said contract or contracts. Withdrawals from such account shall be by check or similar instrument signed by Principal and countersigned by a representative of Surety. Said trust or trusts shall terminate on the payment by Principal or indemnitors of all the contractual obligations for the payment of which the trust or trusts are hereby created or upon the expiration of 20 years from the date hereof, whichever shall first occur.²³

- **Earmarking**

When funds are transmitted to the contractor under an explicit agreement and the express instruction of the party providing the funds to the contractor that they are to be applied only to specified subcontractors for work performed on the Project, the funds are said to be “earmarked,” the contractor is merely a conduit, and the funds cannot be said to have ever truly belonged to the debtor’s estate.²⁴ As one federal appellate court literately described the earmarking concept:

In every earmarking situation there are three necessary dramatis personae. They are the ‘old creditor’, (the pre-existing creditor who is paid off within the 90-day period prior to bankruptcy), the ‘new creditor’ or ‘new lender’ who supplies the funds to pay off the old creditor, and the debtor. When new funds are provided by the new creditor to or for the benefit of the debtor for the purpose of paying the obligation owed to the old creditor, the funds are said to be ‘earmarked’ and the payment is held not to be a voidable preference.²⁵

Joint check agreements and zero-balance control accounts are common examples of earmarking in action. Sureties are cautioned that the earmarking principle is most securely implemented not by itself, but in furtherance of a trust such as discussed earlier in this section – earmarking underscores that proceeds flowing through the principal’s hands do not belong to it but are intended for specific recipients. For instance, money from surety advances and project proceeds would be passed

²³ THE SURETY’S INDEMNITY AGREEMENT: LAW & PRACTICE 142 (Marilyn Klinger et al. eds., American Bar Association, 2002).

²⁴ “Under the earmarking doctrine, when a third party advances or loans funds to the debtor with instructions to use the funds to pay off another creditor, the funds are said to be earmarked for payment to a specific creditor or creditors and do not become property of the debtor.” *In re Sierra Steel, Inc.*, 96 B.R. 271, 274 (9th Cir. BAP 1989).

²⁵ *In re Bohlen Enterprises, Ltd.*, 859 F.2d 561, 565 (8th Cir. 1988).

through a validly established joint control trust account, with checks being deposited into the account specifically identifying the subs intended to receive the funds when subsequently disbursed from the account.

FINANCING AGREEMENTS TO PROTECT COLLATERAL AND PROJECT FUNDS FROM PREFERENCE CLAIMS

When the surety anticipates the possible bankruptcy of its principal, it has the opportunity to plan for effective management of that potentiality with an eye toward preserving collateral and contract funds from preference claims. A carefully structured financing agreement is an important tool to accomplish these ends, using the trust fund and new value concepts discussed above in a coordinated manner.

Collateral given to the surety at the time of financing is protected from preference claims because the surety is giving new value to the principal in the form of loans, sometimes coupled with new bonds. The surety has no duty to finance the principal, either in general or even specifically to keep the bonded project going. Indeed, the surety is not even bound to give the principal the opportunity to complete the bonded project following default. Where the principal would be unable to move forward towards completion of the project without the infusion of surety financing, such financing permits the bonded project to proceed to completion in a more normal and less onerous fashion than would be possible if the project first fell badly into default and then had to be pulled out of the proverbial ditch. In turn, such an arrangement protects the principal's business reputation and good will, preserves favorable credit terms with its existing vendors, and more. Thus, a financing agreement brings new value to the principal both in the obvious form of the loaned money, and through these less tangible but important benefits that flow from keeping the project on track.

Trust concepts are nearly indispensable for building protection of contract proceeds, surety's infused funds, and payments made to creditors from preference claims when a financing agreement is entered. As noted above, assuming that state law requirements are satisfied for the creation of a valid trust, a joint control trust account gives the surety a conduit through which project funds and surety advances can safely be passed to subs and other creditors of the principal. The payments are shielded from the trustee's preference avoidance powers since the money paid into the account then used to pay subs and creditors never becomes property of the estate. The trust agreement designates the surety as a trust beneficiary, and possibly project claimants, too, and the purposes of the trust are detailed, including principally the payment of expenses to complete bonded projects. The flow of contract funds into such an account and out to subs does not improve the surety's position, diminish the estate, or create avoidable preferences, given the trust imposed on the incoming funds to keep them from becoming the principal's property, and given the surety's equitable subrogation rights in project funds held by the owner and the corresponding release of the surety's equitable lien which occurs upon payment of subs.

Since subs are accustomed to signing a waiver and release to obtain a payment on the project, the surety should maximize this opportunity by requiring in the financing agreement that the surety-financed principal have subs release any claims against the surety arising out of or related to a preference action, should the principal end up filing for bankruptcy, in addition to the more traditional release of lien rights associated with the work being recompensed. While such an additional release at the time of payment on the face of it benefits the surety rather than the principal, it still arguably adds an additional line of defense to any preference claim as a “contemporaneous exchange of new value.” The release induces the surety to make a payment which extinguishes the surety’s right of equitable subrogation over contract funds to that extent.

This concept of the sub releasing all claims arising out of the principal’s bankruptcy in exchange for payment, as establishing a contemporaneous exchange for new value defense to a later preference claim, is an important tool for a surety to have in its kit. It is a useful concept even for situations less complex than financing of principals, such as protecting payments a principal makes with money he has begged out of the surety as “look-see money” when he gets in an 11th-hour jam and is straining to keep a project going. Since the principal in such a situation may very well want the payment to come from him rather than the surety so as not to telegraph his financial weakness to subs, the surety can provide the principal with form release language and insist that the principal include it in the release which the sub is required to execute to receive payment. The release might read in relevant part:

Without in any way limiting the foregoing, Sub hereby forever waives and releases Surety from any and all claims and causes of action arising out of or related to any bankruptcy filed by Contractor, including but not limited to claims and causes of action arising out of or related to any preference action connected with such bankruptcy.

SURETY’S REACTION TO PREFERENCE ACTIONS AGAINST SUBS

As discussed in the preceding section, some defenses to preference actions can be put into effect by the surety taking careful action at the time the subject payment is made, to set into place conditions which legally protect the payment from the trustee’s avoidance power (e.g., imposition of a trust, earmarking). Most often, however, the defenses must simply be asserted at the time a preference action is brought, looking back to the facts of the transfer.

A surety may not necessarily know that a preference action is being asserted against a sub in time to do anything about it. Once a preference action is adjudicated and the sub, compelled to return the payment to the bankruptcy estate, makes a claim on the bond, it is too late for the surety to argue about whether a more aggressive or more informed defense by the sub would have defeated the preference claim.

When a surety does learn of the preference action while it is pending, and assuming it is thought to be both defensible and of sufficient magnitude to justify a defense, the surety must decide whether to be proactive. The surety may seek to intervene to assert the defenses available to the sub, or the surety may invite the sub to file a third party claim to bring the surety into the litigation. Either way, the surety has interests that will be affected by the outcome of the trustee's preference action which are highly unlikely to be protected in its absence from the litigation: the sub has no real motivation to resist the return of the payment, since the surety is standing there with the obligation to pay the sub on the payment bond as soon as the Trustee takes back the money as a preference. Not only that, but the sub's attorney may not be aware of or understand these preference defenses sufficiently well to argue them effectively, especially in the specialized context of surety law.

THE STATUTE OF LIMITATIONS DEFENSE

It is not difficult to imagine that preference litigation can result in a sub having to return a payment to the bankruptcy estate after the expiration of the one year statute of limitations for a bond claim under the Miller Act and most Little Miller Acts. Similarly, there may be time limitations in the payment bond itself (typically one year from the sub's last delivery of labor or materials to the project) which lapse before a preference action results in the sub losing a payment. In fact, preference litigation may not even *begin* until such time has run. Regardless, the sub now faces the prospect of having a claim on the payment bond arise only *after* the deadline for making such a claim.

In such situations a sub may try to convince a court that these limitations should be found to have been tolled on equitable principles, thus permitting the sub to bring an otherwise time-barred claim on the bond. The surety has strong grounds to refute such an argument. Initially, it is important to assert that such statutory or contractual limitations simply mean what they say – it is a fundamental common law principle that unambiguous statutory and contractual provisions are entitled to be enforced according to their plain language.

If a sub seeks to garner the court's sympathy for its predicament of finding itself disgorge of a payment *after* the limitation period has run for making a bond claim, the surety can show the court that the sub has nobody to blame but itself for not anticipating and addressing the possibility. For instance, the sub could have sought a tolling agreement from the surety. The surety community is familiar with the use of tolling agreements, but courts may need to be educated in how commonly they are used, to understand the sub's negligence in not seeking one. An affidavit from the surety claims representative is the best tool for so educating a court. The sub also could have petitioned the bankruptcy court to shorten the time within which a preference claim must be asserted. The sub could have sought to join the surety as a party to the preference claim, so that all of the related and contingent rights and duties could be adjudicated with all interested parties present in one proceeding. Finally, the sub could have filed a declaratory judgment action against the surety to resolve any uncertainty over its right to

pursue a claim on the bond for payments lost to preference claims. These arguments are raised as strategic considerations; there is little relevant case law involving sureties.

CONCLUSION

Sureties have unique and broad rights which arise from the unique and broad obligations they undertake in bonding construction projects. Bankruptcy courts, claimants and attorneys who do not represent sureties tend to be ignorant of these principles of surety law, and their application in the context of the construction industry and bankruptcy. As a result, preference claims present a special challenge to sureties, who must be prepared to educate all the players thoroughly if they are to have the benefit of these unique protections the law gives them.

BIBLIOGRAPHY

The following are excellent resources that specifically address bankruptcy issues as they apply to sureties and the construction industry, which were consulted in the preparation of this article.

- THE MOST IMPORTANT QUESTIONS A SURETY CAN ASK ABOUT BANKRUPTCY (Deborah S. Griffin and Doreen Spadorcia, eds., American Bar Association, 2nd ed. 2003).
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