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BANKRUPTCY PREFERENCE CLAIMS: Can They Really Do That?

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BANKRUPTCY PREFERENCE CLAIMS:
Can They Really Do That?

I.
OVERVIEW

This paper will discuss, generally, bankruptcy law and how it impacts a situation where a bonded Principal has sought bankruptcy protection. Once a Principal on a payment and/or performance bond has made that fateful decision to file bankruptcy, many different things are set in motion, and in some instances, time will stand still as far as the issue of "who gets the money".

Naturally, the Surety, pursuant to its General Agreement of Indemnity and statutory responsibilities, will argue that any funds still existing with the obligee, or with the Principal, are rightfully its property. However, there are other claimants and issues at work, which are both at odds with the Surety's interest, as well as compatible. This paper is not intended to be a definitive statement of bankruptcy law. Rather, this paper and presentation is intended to provide a basic understanding of the issues that occur once a Principal files bankruptcy. The Surety professional and Surety counsel should have a basic understanding of the bankruptcy issues, so that it can properly guide the surety through the situation. Generally, outside bankruptcy counsel will be most effective in actually litigating these matters within any bankruptcy proceeding.

This paper will first discuss the characterization of the funds that are available upon a bankruptcy filing, and define the competing interest to those funds. Second, the preferential payment claims that always arise in a bankruptcy will be addressed, with explanations of the various issues that arise in the preference actions when the principal General Contractor has filed for bankruptcy protection. Third, the major defense to a preference action will be discussed. Generally, the bankruptcy trustee will file multiple lawsuits against all parties who are paid any funds from the bankruptcy estate in the 90 days leading up to the date the bankruptcy was filed. Many issues surround these types of adversary proceedings, and the Surety will be right in the middle of each of them.

II.
CHARACTERIZING THE FUNDS

A. Funds Retained by the Trustee

A bankruptcy trustee is the individual vested with powers to maintain or distribute the assets of the bankruptcy estate. For the purposes of this paper, the bankruptcy estate would be the estate of the Principal on the payment and/or performance bond at issue at that time. Normally, the Principal would be the General Contractor on a construction project. The Trustee is usually a person familiar with the bankruptcy courts, and has broad experience and practice within the bankruptcy court to which he/she has been appointed as trustee.

One of the most important aspects of any hope of recovery for any claimant would be receiving the share of funds that are retained by the trustee. The trustee has presumably taken inventory of the debtor's estate, and has consolidated both liquid and non-liquid assets. The trustee will also take an inventory of secured liens against any of the property of the estate, such as purchase money liens and internal revenue service claims. Without getting into a lengthy discussion of the intricacies of bankruptcy law, secured claimants, such as purchase money lenders, holders of UCC liens and the Internal Revenue Service take precedent over other creditors. It is the remaining pot of money the rest of the claimants will fight over in various classifications.

B. Funds that are Subject Matter of claims Made by Obligee

Another competing claimant to the funds held by the Trustee would be the Obligee on the payment and performance bond. The Obligee, generally, has forwarded funds to the Principal, with the probable understanding the Principal would utilize the funds in whatever construction project is undertaken. That does not always happen, and often is a litigated topic in construction related bankruptcies in those states that recognize construction trust funds.

However, the Obligee will claim that properties in the possession the bankruptcy debtor are its funds, and not actually the property of the debtor. The "trust fund" issue is debated widely from the perspective of Obligees, Principals and bond claimants. Did the General Contractor/Principal/Bankruptcy Debtor actually own those funds when it left the hands of the Obligee, and before the money reached its ultimate intended source? Are the funds still the property of the obligee? These issues will need resolution before estate proceeds are distributed.

C. Claims Made by Payment Bond Beneficiaries

The perfect counterpart to the Obligee's claim to funds and property in the hands of the bankruptcy trustee would be claims made by a payment bond beneficiary. The payment bond beneficiaries, or "hoped-for" payment bond beneficiaries, will also claim the trust fund status of the funds being held by the bankruptcy trustee. A problem occurs when "hoped-for" payment bond beneficiaries were denied their rights to make a payment bond claim, as they had already been paid. This topic will be the subject matter of the preferential payment bond issues in the section to follow. Nonetheless, payment bond beneficiaries, who have not yet been paid, and have not made an appropriate bond claim, can still claim the retained funds are trust funds for the benefit of the subcontractors and the vendors.

III.
PREFERENTIAL PAYMENT CLAIM REQUIREMENTS

A. What are Bankruptcy Preferential Payments?

Bankruptcy preferential payments are active grounds for litigation in the construction and surety world. In a nutshell, preferential payments are any payments that were made by the bankruptcy debtor, to any third party vendor, or outside source, in the 90 days leading up the bankruptcy filing. Generally, all sureties, subcontractors and vendors will be the target of a preferential payment allegation if payments or transfers were made within 90 days of the bankruptcy filing. As stated above, the pot of money from which most claimants seek to recover comes from those funds retained by the trustee. The trustee has a single-minded interest in increasing the size of its pot. Preferential payments and the recovery of preferential payments are often seen as a profitable way to make the pot grow.

Generally, bankruptcy preferential payments become the focus of an adversary action filed by the bankruptcy trustee against some or all individuals and entities that received payments from the bankruptcy debtor in the 90 days leading up to the filing of the bankruptcy. This type of litigation is costly, often involving several parties, and can appear to be a war of attrition. There are many different defenses to a preferential payment allegation in an adversary proceeding. These defenses will be identified below, and the major defenses will be discussed in detail.

B. The Applicable Bankruptcy Code Provisions

Preferential payments made under federal bankruptcy law are generally described in 11 U.S.C. § 547(b).[1] The following are requirements the trustee must meet in order to successfully prosecute a preference claim in the bankruptcy court:

1. The property that was transferred must have been one in which the debtor had some interest;

2. The transfer of the property (i.e., payments) must have been made to the creditor, or in some way benefited the creditor;

3. The payment to the creditor must have been in payment of an antecedent debt owed by the bank principal to the creditor before the transfer was made;

4. The transfer must have been made while the debtor was insolvent; and

[1] 11 U.S.C. § 547(b).

5. The transfer of funds or payments must have left the creditor better off than if the transfer or payment had not been made and the creditor had simply asserted its claim in the Chapter 7 bankruptcy.

In order to succeed in a preference action, the Trustee must prove all these elements described in 11 U.S.C. § 547(b).[2] If the Trustee or Debtor can not prove all five elements, they will not win the case. The principle behind preference payments, as they are defined in the bankruptcy code, stem from the goal of the bankruptcy court, wherein all creditors are to be treated as equals within their class.[3] Targets of preference payments adversary proceedings rarely see the fairness described in many cases.

C. The Debtor Must Have an Interest in the Property at Issue.

The first element necessary for the Trustee to prove its preference action is that the property or payment transferred from the Debtor to the Creditor (in this case the Surety) must have been one in which the Debtor held an interest.[4] Preference actions are usually based upon payment of money or money equivalents, or a payment of the debt in some manner. In the context of a Surety, or a payment bond claimant, the payments are generally cash. However, preference payments could take just about any form, and are not necessarily limited to cash. As a Surety, payments made from a bankrupt principal, to one of its subcontractors or vendors, could conceivably be the subject matter of a preference payment.

As stated earlier, the Surety will take the position that funds retained by the bankruptcy trustee, at least in part, are funds that are the property of the Surety under the General Agreement of Indemnity, and are not property subject to the bankruptcy estate.[5] However, if a principal seeks bankruptcy protection, and during its last three months of operation paid vendors and subcontractors, those vendors and subcontractors probably have given up their legal ability to file a bond claim under the applicable statutory scheme at issue. In those very common situations, the Surety must tread the fine line between demanding funds under its General Agreement of Indemnity, and realizing that it may benefit from actual payments the Principal made to vendors and subcontractors during the three months leading up to its bankruptcy. The import of this situation occurs when the Surety takes the position it is entitled to construction fund proceeds, under its General Agreement of Indemnity, statutory and bond obligations,

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[2] See also, *T.B. Home Sewing Enterprises, Inc. v. Tulip Production,* 173 B.R. 782 (Bankr. N.P. Ga., 1993).
[3] See *Begier v. IRS*, 110 S.Ct. 2258, 2263 (1990).
[4] The general scope of the debtor's bankruptcy estate includes legal and equitable interests of the debtor in property at the time the suit is filed. If the debtor does not have any equitable interest in property he holds in trust for another, then this interest is not property of the estate, and the funds should not be utilized to generally pay creditors. *Begier v. IRS,* 110 S.Ct. 2258, 2263 (1990).
[5] See *In re I.T. Group, Inc.,* 326 B.R. 270 (Bankr. D. Del. 2005), where a court commented that property held in trust by the debtor for the benefit of a creditor is not property of the debtor's estate and is not an interest of the debtor in property for purposes of preference actions, citing *5 Collier on Bankruptcy,* pp. 541.11 (Allan N. Resnick and Henry J. Sommer, editors, 15th e.d. r.e.v.).

and is also entitled to any monies returned pursuant to preference actions the Trustee pursues under the bankruptcy code.[6]

Clearly, one of the defenses to a preference suit concerns "Trust Funds". The Surety, the subcontractors and the vendors of any bankrupt principal will, and can claim that the construction fund proceeds were never the property of the bankruptcy estate. Rather, the money the bankrupt principal paid to the subcontractors and vendors, and hopefully to the Surety, before the bankruptcy was filed, were merely "pass-through" trust funds. Therefore, it is probably of great benefit to the Surety to work out "payments" before the principal goes through with its bankruptcy. However, the Surety has no power to settle the "trust fund" issue before the bankruptcy is filed, if the principal is not or has not cooperated. The Surety will simply rely on its obligations and powers to exercise control of construction fund proceeds if a default occurs, and fight for the funds retained by the principal, and later, the Trustee.

D. Payments Benefited the Creditor

The second required element of a preference action, on behalf of the bankruptcy trustee, requires the payment made to the creditor actually does benefit the Creditor. An interesting question crops up in this area because of the particular and peculiar relationship between Principal and Surety. Is the Surety a creditor? More likely than not, the Surety would be considered a Creditor because when the Principal paid construction proceeds to the Surety, it would benefit the Surety as an offset to payment and performance bond claim payments that may be made in the future. However, these are counter-arguments to that approach.

An argument can be made that pre-petition payments made on behalf of a Principal, to the Surety were nothing more than the Surety acting as a conduit for payment to payment bond beneficiaries, and obligees.[7] In one case, the court rejected a contractor's argument that it was merely acting as a pass-through for payments to subcontractors and vendors. This Court held the contractor did retain some of the funds itself as profits, and pointed out the contractor did exercise dominion and control over the contract proceeds in order to discharge its own contractual obligations to pay its subcontractors.[8] Analogizing this to a Surety situation, the court will likely hold that payments made on behalf of the principal to the Surety, pre-petition would constitute payments made to a Creditor, and benefiting a Creditor if the payments were made pursuant to the obligations imposed by a General Agreement of Indemnity. However, the Surety can avoid the preference action by successfully arguing that it had taken control of the construction fund proceeds and was entitled to confiscate related items under its General Agreement, the statutory requirements, or the bond.

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[6] 11 U.S.C. § 547(b).
[7] *See, generally, Webster v. E.I. Kane Construction, Inc.*, 2004 Bankr. WL 313071 (Bankr. D.D.C.2004). Where bankruptcy law deals with property rights governed by state law, federal courts will look to the state law and state court cases to determine what are the property rights. *Chicago Board of Trade v. Johnson,* 44 S.Ct. 232 (1923).
[8] *Id.*

Similarly, the third requirement of a preference claim, is that the payment must have been made of, or on account of an antecedent debt owed by the Debtor to the Creditor before the transfer was made. This term "antecedent debt" simply means a debt that existed before payment was made. Logically, if payment was made from the principal to the surety under the General Agreement of Indemnity, the debt would have existed before the payment was made. However, once again, the Surety may successfully argue the payments were not a debt, and were nothing more than an assignment of proceeds as described above.

E. When is the Principal "Insolvent"

The fourth element of a successful preference action by the Trustee would require a showing that the principle debtor was insolvent when the alleged preference payment was made. If the Surety can show that the Principal was solvent when the payments were made, then the Trustee would fail in its preference action. The term insolvent means a financial condition where the sum of an entity's debt is greater than all of the entity's property, at a fair valuation, exclusive of exempt property, or property that was transferred, concealed or removed with the intent to hinder, delay or defraud such entity's creditors.[9]

There is a statutory presumption of insolvency on and during the 90 days immediately preceding the filing of the petition for bankruptcy.[10] The presumption is all the Trustee needs to utilize, unless the Surety or another Creditor can show that the bankrupt principal was in fact solvent during this time period. If a Creditor, such as the Surety, does come forward with some evidence of solvency, the Trustee loses the benefit of the presumption and has to prove its case.

Closely monitor the principal's financial condition during any time period leading up to bankruptcy. If a catastrophic event occurred, and bankruptcy quickly followed, an accounting expert can be utilized to prove the bankruptcy estate was solvent during the relevant time period. Likewise, if the principal has been operating in a deficient situation, and borrowing from one job to pay another, the insolvency/solvent issue may not be the best defense.

F. The Creditor must be better off than if it made its Claim in the Bankruptcy Proceeding

The final requirement under the Bankruptcy Code to successfully prosecute a preference claim concerns the fact the payment must have left the Creditor better off than if the payment had not been made and the creditor had asserted its claim in the Chapter 7 liquidation.[11] Clearly, the surety, if it is to claim that it is entitled to the funds

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[9] See 11 U.S.C. § 101(32).
[10] See 11 U.S.C. § 547(f).
[11] See 11 U.S.C. §547(b)(5); and see also the test for this element established by the Supreme Court in *Palmer Clay Products Company v. Brown,* 56 S.Ct. 450(1936); see also, *Elliot v. Frontier Properties,* 778 Fed.2d 1416 (9th Cir. 1986).

outside the bankruptcy estate pursuant to the General Agreement of Indemnity, or is avoiding the preference action on that basis, will be better off with its payment, than it would be if the funds were simply included in a Chapter 7 liquidation pot. However, the analysis is not quite that simple. For example, the Surety is no better off if it simply required property it had a right to receive under its General Agreement of Indemnity or by statute.

Both the insolvency and "liquidation" issues will probably require expert accounting testimony. For a payment bond beneficiary claimant, this issue becomes quite important as the payment bond beneficiaries have been denied their rights to file payment bond claims, as they had already been paid.[12] Likewise, the surety could argue that pre-petition payments made under the General Agreement of Indemnity were funds that it could have sought directly from the Owner (presumably at some point this did take place), if the principal's accounts were not confiscated directly.

In any event, pursuing the insolvency and liquidation defenses would require, in most cases, expensive expert opinions, and should be pursued if feasible, with an eye towards some other defenses that may in fact hold better chances of success.

IV.
DEFENSES TO PREFERENCE CLAIMS

A. Were the Principal's Payments made in the Ordinary Course of Business?

Determining if the potential preference payments were made in the ordinary course of business is generally the leading defense in the preference action. The "ordinary course defense" is available to a Creditor and permits the Creditor to retain transfers made from the Debtor to the Creditor during the preference period.[13] However, three requirements are necessary to prove this exception to the avoidable transfer:

1. The payment was made for a debt incurred in the ordinary course of business of the parties;
2. The payment was made in the ordinary course of business of the parties; and
3. The payment was made in accordance in the ordinary business terms.[14]

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[12] See *Cunningham v. T&R Demolition,* 301 B.R.195 (Bankr. N.D. Tex. 2003). In that particular case, the court agreed that the subcontractor was not better off than it would have been under the Chapter 7 liquidation, as he could have filed a bond claim against the Debtor's surety if the payment had not been made. See also *Webster v. E.I. Kane Construction, Inc.*, 2004 Bankr. WL 3130571 (Bankr. E.D.C.2004) (the opposite occurred in that particular case).

[13] See, *In Re Forklift LP Corp.*, 340 B.R. 735 (Bankr.D.Del., 2006).

[14] *Id at* 738. See also, *In Re Fred Hawes Organization, Inc. (Logan v. Basic Distribution Corp.),* 957 Fed.2d 239, 243 (6th Cir. 1992).

The preference rule and the ordinary course of business exception to the preference rule are intended to balance the interest of the Debtor and the Creditor.[15] A Third Circuit Court of Appeals quote states very clearly this principle:

> On the one hand the preference rule aims to ensure the Creditors are treated equitably, both by deterring the failing Debtor from treating preferentially its most obstreperous or demanding Creditors in an effort to stave off a hard ride into bankruptcy, and by discouraging the creditors from racing to dismember the Debtor. On the other hand, the ordinary course exception to the preference rule is formulated to induce Creditors to continue dealing with the distressed Debtor so as to kindle its chances of survival without a costly detour through, or humbling ending in, the sticky web of bankruptcy.[16]

This stated principle indicates that bankruptcy law favors an attempt at avoidance of bankruptcy, by encouraging continued business dealings with the potential bankruptcy debtor.

Along these lines, the debt incurred, and eventually paid needs only to have been occurred in an ordinary manner, based on the consistency with other business transactions between the parties.[17] Likewise, a transaction between the parties can be ordinary even if it occurs only occasionally between the parties.[18] The factors to determine if payments were made in the ordinary course of the parties' business, include (1) the length of time the parties engaged in the type of dealing at issue; (2) whether the subject payments were in the amount more than usually paid; (3) whether the payments at issue were tendered in a manner different from previous payments; (4) whether there appears to be an unusual action by the Debtor or the Creditor to collect or pay the debt; and (5) whether the Creditor did anything to gain an advantage (such as gain additional security in light of the Debtor's deteriorating financial condition.[19] When the parties have a long history of business together, the court can look at the history of dealings; but where the parties have a shorter history of dealings, the Creditor is required to put on more extensive evidence of the industry standards.[20] For example, a pattern of late payments can establish ordinary course of business between the parties.[21]

Clearly, expert testimony would be required to prove the standards of the industry in determining if a payment was made in the ordinary course of business. In the Third Circuit Court of Appeals, for example, the Court requires the Creditor to establish a range of terms that would be ordinary for firms similar in some general way

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[15] *Id.*
[16] In re Molded Acoustical Products, Inc., 18 F.3d 217, 219 (3d Cir.1994).
[17] *Id. citing, In re Valley Steel Corp.,* 182 B.R. 728, 735 (Bankr.W.D.Va.1995).
[18] *See J.P. Fyfe, Inc. of Florida v. Bradco Supply Corp.*, 891 F.2d 66, 69–70 (3d Cir.1989).
[19] *Id. citing, In re Parkline Corp.,* 185 B.R.164, 169 (Bankr.D.N.J.1994).
[20] *Id. citing, In re U.S. Interactive, Inc.*, 321 B.R. 388, 392–93 (Bankr.D.Del.2005).
[21] *Id. citing, In re Big Wheel Holding Company,* 223 B.R.669, 674 (Bankr.E.Del.1998).

to the Creditor.[22] This subjective look at the industry standards will require exact expert opinion.

For the Surety, the ordinary course of business defense can be important in two ways. First, the potential payment bond claimants, who are also the subject of preference actions by the bankruptcy trustee, can utilize this defense in order to defend payments made to them. Secondly, the Surety can utilize the defense in avoiding any preference actions where the Surety has taken over a construction project, and the books and the accounts receivable of its principal. As long as a properly documented default has taken place, and the Surety is acting in accordance with its obligations, duties and rights under the General Agreement of Indemnity and appropriate statutory law, the ordinary course of business defense should be available, and hopefully successful.

B. Were the Principal's Payments "Trust Funds"?

The trust fund issue has been raised defensively in preference actions all across the country, with varying results. This area of the law generally refers to the notion that the bankrupt principal (such as the general contractor) did not actually own the funds paid to either the Surety, or vendors and subcontractors, therefore, precluding the preference action filed by the Trustee. In many states, the Construction Trust Fund Doctrine is codified expressly by state statute.[23] In many other states, the Construction Trust Fund theories and principles have been adopted through common law and equity principles.[24] Regardless of whether the construction trust funds scheme is statutory, or based upon common law and equity principles, the theory can be used to quash the ability of the Trustee to recover preference payments made during the preference period.

One bankruptcy court, in generally discussing the trust fund issues and theories, in the context of preference payments, placed a great deal of emphasis on the fact that trust fund laws in the various states impose duties upon the owners and contractors to make sure that all subcontractors and vendors are paid with the construction loan proceeds.[25]

Along these same lines, the Fifth Circuit Court of Appeals, addressed a situation where a Surety filed suit against a bankruptcy trustee in an attempt to recover a check paid to the bankrupt principal from the owner/obligee on a construction project. The court held that the Surety was entitled to recover the proceeds of this check, as the principal had already defaulted on the project, and the Surety was required at that time

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[22] *See, In re Molded Acoustical Products, Inc.*, 18 F3d 217, 226 (3d Cir.1994).
[23] *See generally*, *Selby v. Ford Motor Co.,* 590 F.2d 642 (6th Cir.1979); *Carrier Corp. v. J.E. Schecter Corp.,* 347 F.2d 153 (2d Cir.); and *Georgia Pacific Corp. v. Sigma Service Corp.*, 712 F.2d 962 (5th Cir.1983).
[24] *See generally, United States v. Durham Lumber Co.,* 80 S.Ct.1282 (1960). See also, *Chicago Board of Trade v. Johnson,* 44 S.Ct. 232 (1923).
[25] *See generally, Bethlehem Steel Corp. v. Tidwell,* 66 B.R. 932 (Bankr.M.D.Ga, 1986).

to complete the project.[26] The court reasoned that since the contractor had defaulted before the check was received by the bank, the Surety had already replaced its principal on the construction contract and had become exclusively entitled to the payments thereon.[27] The 5th Circuit went on to state that since the Surety is legally obligated to the obligee to complete and finance the completion of the construction project, the Trustee, and other claimants should not be entitled to funds received by the bank, from the obligee, after default occurred.[28]

The Trust Fund Doctrine is not uniformly followed through all jurisdictions, in exactly the same manner. The bankruptcy practitioner should be able to advise on a state by state, and case by case basis if the Trust Fund defense is viable, for either a Surety, or another claimant.

C. New Value

A defense that may not necessarily be something the Surety could utilize, is the concept of "new value". A new value defense can be found at 11 U.S.C. § 547(c)(4).[29] Under this defense, payments to a creditor during the preference period can be compared to goods or services supplied by him during the same period without regard to the sequence of events. If the creditor is paid more than he supplied, the difference would be an avoidable transfer. However, if the creditor was paid less than he supplied there is no avoidable transfer.[30]

In short, if there is basically a contemporaneous exchange between a vendor or supplier, and the bankrupt principal, during the preference period, the new value defense can be utilized. While this type of defense does not have many practical applications to the Surety, it needs to be discussed in the event the situations arise in the bankruptcy court. In order to receive protection under the bankruptcy code, the creditor must have supplied new value to the debtor. *Id.* 11 U.S.C. §547(c)(4). This defense is somewhat difficult to utilize, but nevertheless should be considered if applicable.

D. Can a Bond Claim be received after a Successful Preference Action?

After all the defenses have been put forth, and the preference action is completed, one singular question can remain. Can a subcontractor or vendor, who failed to make a bond claim during any of the statutorily prescribed periods, revive its bond claim if it fails in its defense of a preference action. The answer is not easy. It is likely that a bankruptcy court could not revive a bond claim if it was never filed during

[26] *See, Pacific Indemnity Company v. Grand Avenue State Bank of Dallas, Texas,* 223 F.2d 513 (5th Cir.1955).
[27] *Id.*
[28] *Id.*
[29] 11 U.S.C. § 547(c)(4).
[30] See, *Garland v. Union Electric Co.,* 19 B.R. 920 (Bankr. E.D.Mo. 1982).

any statutory prescribed period. The potential bond claimants paid by the principal during the preference period, are simply out of luck with regard to their bond claims if they are unsuccessful in defending the preference claim action by the Trustee. On the other hand, the fact they were denied the opportunity to make a bond claim should remove the claim from a "preference" characterization.

However, an interesting situation may arise if a bond claim was properly perfected by a claimant, and then seemingly extinguished when the principal made the payment during the preference period. Can a bond claim that was actually timely filed, then seemingly extinguished come back to life? The answer to that question has not been fully adjudicated, and will be decided on a case by case basis.

One way for a potential payment bond claimant to protect itself, would be to have any payments made, after filing a bond claim, subject to an agreement by the Surety, that it will honor the bond claim, if the payments made by the principal are later the subject of a successful preference action. Claimants would need to utilize a great amount of foresight in obtaining this type of agreement, or may do it as a matter of course when receiving payments from a principal after a bond claim is timely filed.

V.
CONCLUSION

When faced with a scenario where a Principal has filed bankruptcy, the Surety must initially accomplish a few things. First, the Surety needs to characterize any of the funds over which it has control, and analyze any funds, property or other assets of the Principal's estate now under the control of the bankruptcy trustee. It may be that many of the assets of the bankrupt principal's estate are actually property that should be in the possession of the Surety, regardless of the actual dominion and control over the funds at the time of the bankruptcy filing. Under a General Agreement of Indemnity, and various statutory provisions, the Surety has an obligation to honor certain payment bond claims and if a default occurs, facilitate completion of the bonded construction project. Once the default occurs, the Surety may be entitled to any further proceeds under the Principal's contract, and may have the ability to exercise control over many assets. It is almost guaranteed that the bankruptcy trustee, and its lawyers will not agree the Surety is entitled to any of the assets. The bankruptcy trustee will likely take the position that the Surety is a Creditor, and its claim should be decided on the same level as all others in its creditor class.

Often when a bankrupt principal has made payments to vendors, subcontractors and the Surety during the 90-day period leading up to the filing of bankruptcy, the bankruptcy trustee will seek to recover those funds in adversary preference payment lawsuits. These suits can sometimes involve many different parties, and litigation can be quite expensive.

In order to avoid the negative effects of a preference payment action filed by the bankruptcy trustee, the Surety, and any other target of these types of claims may use

certain defenses. First, the bankruptcy trustee must prove all the requirements of 11 U.S.C. § 547(b). Negating any one of these elements of the preference claim, will cause the claim to fail. In addition, there are certain defenses that any target of a preference claim may utilize.

One major defense is that of claiming that the payment was made in the "ordinary course of business". This defense occurs when a debt was incurred, and a payment was made in the ordinary course of business. Ordinary course of business may be analyzed from a lengthy history of activity between the parties, or it can be established by expert testimony of industry standards, if the transactions between the parties are limited. A Surety's exercise of dominion and control over construction proceeds and other assets of the bankrupt principal should be considered in the ordinary course of business, as it is unlikely that a bankruptcy trustee can find a credible industry standard expert witness to claim otherwise.

Another major defense to a preference action would be to claim that the funds that were paid to subcontractors and vendors are nothing more than trust funds. Many states have trust fund statutes, and other states take a common law or equity approach to trust funds. However, it can be argued in any jurisdiction (sometimes not quite so successfully), that funds paid to subcontractors, vendors or the Surety during the preference period were nothing more than trust funds and were not ever the actual property of the bankrupt principal. A third major defense of New Value, requires a basic showing of a contemporaneous exchange of goods, services or money.

Finally, the Surety needs to be cognizant of a situation where vendors and subcontractors, who were paid during a preference period and failed to perfect a bond claim, may try to revive their bond claim if they are forced to repay money to the estate. This may happen when a bond claim was made, a payment was made by the Principal, and later the claimant is forced to pay the funds back to the bankruptcy trustee. In that situation, a bond claim does exist, could be timely filed, and may be still operational. Without regard to statute of limitations issues, this may be problematic for the Surety in certain situations.

As these types of preference payment situations become more common, the Surety may start to see claimants refusing to release bond claims until 90-days after they have deposited principal payments into their accounts. In that sense, the bond claim, if a preference claim is filed, will not have been released. Assuming the case is still within the applicable statute of limitations, a bond claim may still be live.

Once again, this paper was not designed to be a definitive statement of bankruptcy law, but rather a general guide to some of the issues the Surety, and payment bond claimants may face in the event a Principal files bankruptcy. Many of these issues discussed, as they relate to the Surety, have yet to be adjudicated in the Courts of Appeals, and are fertile ground for the creation of new law.