SURETY TODAY PRESENTATION
Given by
Michael A. Stover and George J. Bachrach
Wright, Constable & Skeen, LLP
Baltimore, MD
December 10, 2018

BANKRUPTCY PREFERENCES – THE SURETY'S INDIRECT EXPOSURE FOR PREFERENTIAL TRANSFERS AND POTENTIAL LIABILITY TO THIRD PARTIES

(GEORGE)

I. INTRODUCTION

Last month, Mike and I discussed a surety's receipt of direct preferential transfers from a principal/Debtor, describing the situation as the very definition of a surety "going backwards." However, when a surety receives such a transfer from a principal in dubious financial condition, the surety should be aware that a preference situation may exist later if the principal files for bankruptcy, and the surety may have to give back the transferred property.

This month we will discuss when a surety can get blind-sided and face exposure for what we will call "indirect transfers" because of the principal's transfers to known or unknown third parties that indirectly benefit the surety. An example is when the principal pays its subcontractors and suppliers, or Claimants, thereby relieving the surety of its payment bond obligations to those Claimants, and then the principal files a bankruptcy case. There are two different ways that a surety may face this indirect exposure.

First, the trustee may sue the Claimant for a preferential transfer – the principal's payment to the Claimant made within 90 days of the filing of the bankruptcy case. The Claimant may then sue the surety under the payment bond, either within the trustee's preference case or after the preference case is resolved through a Claimant settlement with the trustee or a trustee's judgment against the Claimant.

Second, in what is a true "indirect preference action," the trustee may by-pass a preference claim against the Claimant and sue the surety directly under the theory that the surety is the true beneficiary of the principal's pre-petition payment to the Claimant because the surety would otherwise have had liability to the Claimant under the payment bond.

We will start today with a quick overview of preferences generally that we addressed in the November 12 Surety Today presentation, including the substantive elements of a preference and the defenses to a preference, and then proceed to discuss the surety's indirect exposure for the principal's preferential transfers to third-parties.

II. PREFERENCES UNDER THE BANKRUPTCY CODE – SUBSTANCE, PROCEDURES AND DEFENSES

A. The Substantive Elements of a Preference – Section 547(b) of the Bankruptcy Code.

Section 547(b) of the Bankruptcy Code provides the elements of a preferential transfer and states that the "trustee may avoid any transfer[1] of an interest of the debtor in property[2] –

1. to or for the benefit of a creditor;[3]
2. for or on account of an antecedent debt[4] owed by the debtor before such transfer was made;
3. made while the debtor was insolvent;[5]
4. made –

    a. on or within 90 days before the date of the filing of the petition; or
    b. between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider;[6] and
5. that enables such creditor to receive more than such creditor would receive if –

    a. the case were a case under chapter 7 of the Bankruptcy Code;
    b. the transfer had not been made; and
    c. such creditor received payment of such debt to the extent provided by the provisions of the Bankruptcy Code.

To decipher the meaning of Section 547(b), one has to deconstruct the elements and look at a number of defined terms in the Bankruptcy Code. Step #1 – what does it mean to "avoid any transfer of an interest of the Debtor in property?" First, a preference is "voidable," not

---

1 *See* Section 101(54) of the Bankruptcy Code for the definition of a "transfer," which includes the creation or retention of a lien or security interest and any other mode, direct or indirect, absolute or conditional, or voluntary or involuntary disposal of or parting with property or an interest in property.

2 *See* Section 541 of the Bankruptcy Code for the definition of "Property of the estate" and the Surety Today presentation on November 13, 2017.

3 *See* Section 101(10) of the Bankruptcy Code for the definition of a "creditor," which is an entity that has a "claim" against the debtor that arose at the time of or before the filing of the bankruptcy case.

4 *See* Section 101(12) of the Bankruptcy Code for the definition of "debt," which is a "liability on a claim." A "claim" is defined in Section 101(5) of the Bankruptcy Code, and includes a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured" or a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment." "Debts" and "claims" were discussed in the Surety Today presentation on January 8, 2018.

5 *See* Section 101(32) of the Bankruptcy Code and relevant case law for the definition of a "insolvent." *See also* Section 547(f) – for the purposes of Section 547, "the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition."

6 *See* Section 101(31) for the definition of "insiders" and who they are with respect to individuals, corporations, partnerships, affiliates and others.

automatically "void." Second, the "transfer" definition is very broad and includes both a Debtor's voluntary and involuntary disposal of or parting with its property. And third, the transfer must involve "an interest of the debtor in property," which is defined broadly under Section 541 of the Bankruptcy Code as "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case."

Step #2 is the determination that the transfer of the property was made to a "creditor" for or on account of an antecedent "debt" owed by the Debtor to the creditor before the transfer was made. Obviously, the surety is a "creditor" of the Debtor under the pre-petition indemnity agreement and as a result of the execution of the pre-petition bonds for the Debtor, and the Debtor owes an "antecedent debt" to the surety for the surety's actual or potential "claim" under the indemnity agreement and/or the bonds whether that pre-petition Debtor liability is contingent, liquidated, fixed, disputed, undisputed or otherwise at the time of the Debtor's filing of the bankruptcy case.

Step #3 requires that the transfer of the property must occur "while the debtor is insolvent." Section 547(f) of the Bankruptcy Code provides that the Debtor is "presumed" to be insolvent when it files its bankruptcy case, and this may be a hard presumption for a surety to rebut and overcome.

Step #4 relates to the timing of the transfer of property. There are two periods of time that a transfer of property may be avoidable – on or within 90 days before the filing of a bankruptcy case – which we will address as the most frequent timing situation – and for "insider" situations, between 90 days and one year before the filing of the bankruptcy case. There is a long definition of who are the Debtor's individual, corporate and/or other insiders that must be reviewed, but it is very doubtful that a surety can be an insider of a Debtor even though some trustees have alleged this can happen.

Step #5 is the last element, and requires that the creditor receive more than it would have received if the bankruptcy case is a liquidation under Chapter 7 and the amount the creditor receives is greater than the distribution is or will be to other creditors in a like situation. For example, if the surety was an unsecured creditor and then obtained collateral within 90 days of the filing of the bankruptcy case that would provide a 25% repayment of the surety's debt, and yet other unsecured creditors would receive a distribution of only 5% of their debt in a Chapter 7 liquidation, then this element of a preferential transfer would be met.

B. The Procedural Issues for Preference Actions.

As Mike discussed in the November 12 presentation, there are a number of procedural and proof issues that are important to remember.

1. The Debtor's or creditor's intent or motive for the transfer of the property is not material. It is the effect of the transfer itself that controls.[7]
2. A preferential transfer is avoidable, not automatically void, and the trustee must file a Complaint to avoid a transfer.[8]

---

7 *In re Messenger*, 166 B.R. 631 (Bkrtcy. M.D. Tenn. 1994).

3. There is a two-year statute of limitations for the trustee's filing of a Complaint for a Preferential Transfer, and it may be longer if a trustee is appointed during the second year.[9]
4. The trustee has the burden of proving that the transfer is avoidable by proving every element of a preference by a preponderance of the evidence. The defendant/creditor has the burden of proving any defenses by a preponderance of the evidence.[10]

(MIKE)

C. <u>The Surety's Statutory and Other Defenses to a Preference Avoidance Action – Sections 547(b) and 547(c) of the Bankruptcy Code.</u>

There are a number of statutory defenses to a preference avoidance action. As I discussed in detail in the November 12 presentation,[11] the three listed in Section 547(c) that are the most valuable to a surety are the following:

1. <u>Section 547(c)(1) – Contemporaneous Exchange for New Value.</u>[12]

Section 547(c)(1) of the Bankruptcy Code states that a trustee may not avoid a transfer to the extent the transfer was intended by the Debtor and creditor to be a contemporaneous exchange for new value given to the Debtor. So, if the principal pays the premium and at the same time the surety issues the bond, the payment of the premium would not be a preference because the bond is new value issued in exchange. Another example is where this defense is where the Debtor pays COD in exchange for a shipment of materials for a project. The § 547(c)(1) defense is grounded in the principle that the transfer of new value to the Debtor will offset the payment made by the Debtor, and the Debtor's estate will not be depleted to the detriment of other creditors. *Lubman v. C.A. Guard Masonry Contractor, Inc. (In re Gem Constr. Corp. of Virginia)*, 262 B.R. 638, 645 (Bankr. E.D.Va. 2000) (citations omitted). The purpose of this defense is to encourage creditors to continue to deal with troubled entities without fear of having to disgorge payments that were received in exchange for value given.

The Court in *Elec. Metal Prod., Inc. v. Bittman (In re Elec. Metal Products, Inc.)*, 916 F.2d 1502, 1506 (10th Cir.1990) noted that the fact that a creditor may have promised to continue to do business with the Debtor if the Debtor paid its bills is not new credit or new value to the estate. Furthermore, forbearance from exercising pre-existing rights does not constitute new value under § 547(a)(2). However, the Court in *O'Rourke v. Coral Constr., Inc. (In re E.R. Fegert, Inc.)*, 88 B.R. 258, 259 (9th Cir. BAP 1988), *aff'd*, 887 F.2d 955 (9th Cir. 1989) held that the release of a fully secured lien in exchange for payment from the Debtor would constitute new value.

---

[8] *See* Bankruptcy Rule 7001(1).
[9] *See* Section 546(a) of the Bankruptcy Code.
[10] *See* Section 547(g) of the Bankruptcy Code.
[11] *See* the written transcript of the November 12, 2018, Surety Today Presentation.
[12] *See* Section 547(a)(2) for a definition of "new value."

2. Section 547(c)(2) – Ordinary Course of Business.

Section 547(c)(2) provides that the trustee may not avoid a transaction as preferential if the transfer was made in payment of a debt incurred by the Debtor in the ordinary course of business or financial affairs of the Debtor and the transferee, and such transfer was made in the ordinary course of the business or financial affairs of the Debtor and transferee or was made according to ordinary business terms. The ordinary course defense is intended to protect recurring, customary credit transactions that are made and paid in the ordinary course of business.

To establish the ordinary course defense, the question will be was the debt incurred in a typical, arms-length commercial transaction that occurred in the marketplace or as part of routine operations. Once it is established that the debt was incurred in the ordinary course, then it must be proven that *either* the transfer: (1) was made in the ordinary course of business of *both* parties *or* (2) it was made according to ordinary business terms.

3. Section 547(c)(4) – Subsequent New Value.

The elements of this defense are: (1) a creditor extends new value, (2) the new value provided is unsecured and (3) the new value is not repaid to the debtor *after* the preferential transfer. *In re Saco Local Development Corp.*, 30 B.R. 859 (Bankr. D.Me. 1983); *In re Formed Tubes, Inc.*, 46 B.R. 645, 646 (Bankr. E.D.Mich. 1985); *In re Bishop,* 17 B.R. 180, 183 (Bankr. N.D.Ga. 1982). The subsequent new value exception was devised as a solution for the unsecured creditor with a running account who would otherwise find the last 90 days of payments avoided by the trustee in bankruptcy. 4 Lawrence P. King et al., *Collier on Bankruptcy* ¶ 547.12 (15th ed.1994). The defense is based on two policy considerations. First, a creditor who implicitly relies on prior payments in extending additional credit would otherwise increase its bankruptcy loss; and secondly, such creditors should be encouraged to continue their credit arrangements with financially distressed Debtors, potentially helping them avoid bankruptcy. *In re Liberty Livestock Co.,* 198 B.R. 365, 376 (Bankr. D. Kan. 1996).

The surety's additional defenses to a preference avoidance action are found in Section 547(b) itself and are based upon the elements that the trustee must prove by a preponderance of the evidence to find an avoidable or preferential transfer of the Debtor's property. The most important element for today's presentation is whether the Debtor had an interest in the property that was transferred to a third party.

III. THE SURETY MAY BE LIABLE FOR A PREFERENTIAL TRANSFER UPON RECEIPT OF A LETTER OF CREDIT

We and others in the industry have long preached that Letters of Credit are not property of the bankruptcy estate and as such a surety may draw down on a Letter of Credit to satisfy the purposes of the collateral without being subject to a preference action. However, there is a circumstance where the Letter of Credit can be deemed to be a preference.[13] In most cases, a Letter of Credit is issued at the same time or just before the bonds are issued. In such cases, the

13 *See* the Surety Today presentation on December 12, 2016.

issuance of the Letter of Credit is for new value and could not constitute a preference. However, if the Letter of Credit is required sometime after the bonds were issued – let's say to satisfy the surety's concerns about the principal's deteriorating financial condition or to secure the surety for potential anticipated bond losses based on threats of claims - the obtaining of the Letter of Credit would be on account of an "antecedent debt." Further, if the issuance of the Letter of Credit is secured by the principal with cash or other assets pledged to the issuer of the Letter of Credit, such pledge would constitute a transfer. If the principal files bankruptcy within 90 days of the pledge to secure the Letter of Credit, that transfer on account of an antecedent debt may give rise to a preference.

The federal courts have long recognized that "[t]o constitute a preference, it is not necessary that the transfer be made directly to the creditor." *National Bank of Newport v. National Herkimer County Bank,* 225 U.S. 178, 184, 32 S.Ct. 663, 635, 56 L.Ed. 1042 (1912). "If the bankrupt has made a transfer of his property, the *effect* of which is to enable one of his creditors to obtain a greater percentage of his debt than another creditor of the same class, circuity of arrangement will not avail to save it." *Id.* (Emphasis added). To combat such circuity, the courts have broken down certain transfers into two transfers, one direct and one indirect. The direct transfer to the third party may be valid and not subject to a preference attack. The indirect transfer, arising from the same action by the debtor, however, may constitute a voidable preference as to the creditor who indirectly benefitted from the direct transfer to the third party. *Matter of Compton Corp.*, 831 F.2d 586, 591–92 (5th Cir. 1987), *on reh'g*, 835 F.2d 584 (5th Cir. 1988). In this scenario, essentially, the surety went from being a general unsecured creditor to having its debt paid through the Letter of Credit that was facilitated by the pledge of the debtor's collateral. Courts may look through the Letter of Credit to find a preference.

(GEORGE)

IV. THE SURETY MAY BE LIABLE TO A THIRD-PARTY WHO MUST DISGORGE A PREFERENCE

The surety may be liable indirectly to a trustee as a result of a principal's creditor, such as a subcontractor or supplier (or, collectively, a "Claimant"), receiving a preferential transfer from the principal that results in the Claimant making a claim against the surety under a payment bond. This may occur: (a) after the Claimant has been sued by the trustee for the preferential transfer and disgorges the transferred property to the bankruptcy estate, and the Claimant then brings an action against the surety under the payment bond; or (b) the Claimant, upon being sued by the trustee for the preferential transfer, brings an immediate third-party claim against the surety under the payment bond.

The first question is whether the alleged preferential transfer involves property of the bankruptcy estate. That question ties into the form, manner or method of the transfer, namely the payment of money to the Claimant. Of course, the Claimant and the surety have all of the defenses to a preference avoidance action that we have discussed previously.[14]

[14] *See* the November 12, 2018 Surety Today presentation paper for a description of the preference avoidance defenses under Sections 547(b) and 547(c). *See also* Schexnayder, *Ch. 12, Bankruptcy, in* THE LAW OF PAYMENT BONDS, 2D ED, pages 655-673.

(MIKE)

A. <u>The Form, Manner or Method of the Transfer (Payment of Money to the Claimant)</u>

Obviously, claimants may be paid in a variety of ways. When that payment is made within 90 days of the bankruptcy filing by an insolvent principal, the question will arise as to whether such form of payment could give rise to a preference action. Of course, a direct payment by the principal, soon to be debtor, to a claimant could give rise to a preference action because it is a transfer of property of the estate for an antecedent debt (work, services or materials already provided to a project), while the principal was insolvent. But let's look at some other forms of payment:

1. <u>Joint Checks</u>

A common method of payment to subcontractors and suppliers can be in the form of a joint check issued by the bond obligee payable to both the principal and the claimant. Numerous courts have held that payment by joint check does not give rise to a preference action. *See Shaw Inds. v. Gill (In re Flooring Concepts)*, 37 B.R. 957, 961 (9th Cir. BAP 1984); *Zions First Nat'l Bank, N.A. v. Christiansen Bros., Inc. (In re Davidson Lumber Sales, Inc.)*, 66 F.3d 1560, 1568, n. 9 (10th Cir. 1995); *In re Warde Elec. Contracting, Inc.*, 308 B.R. 659 (S.D.N.Y. 2004); *In re Winsco Builders*, 156 B.R. 98, 100-01 (Bankr. M.D. Fla. 1993); *Jackson v. Flohr*, 227 F.2d 607, 610-11 (9th Cir. 1955); *In re Mastercraft Metals, Inc.*, 114 B.R. 183 (Bankr. W.D. Mo. 1990); *In re Sun Belt Electrical Constructors, Inc.*, 56 B.R. 686, 691 (Bankr. N.D. Ga. 1986). The reasoning of the courts generally is that the debtor is a mere conduit with respect to a joint check and has no control over the funds except to endorse the check to the joint payee for whom the funds have been designated. As a result, the debtor has no legal or equitable interest in the funds and they are not property of the estate. As we have noted, for a preference action to exist, the funds that are the subject of the transfer must be property of the estate. *See* Code §547 (b). The Court in *In re Warde Elec. Contracting, supra.*, observed that "[p]roperty held by a debtor merely as a bailee or an agent for a third-party is not property of the estate within the meaning of § 541(a)(1)." *See* Collier on Bankruptcy § 541.06 (15th Ed. 2004). Property of the estate also does not include "any power that the debtor may exercise solely for the benefit of an entity other than the debtor." *Id.* 11 U.S.C. § 541(b)(1).

George and I had a bankruptcy matter for a surety in North Carolina and ran into the minority view on joint checks. The United States District Court for the Eastern District of North Carolina (the very Court where our case was pending) in *Code Elec., Inc. v. Crampton*, 197 B.R. 807 (E.D.N.C. 1996) held that because there was no obligation of the owner to pay a subcontractor of the debtor directly, the joint check constituted property of the estate and was subject to the preference law. In *Code Elec.* the debtor was the general contractor. Prior to bankruptcy the debtor failed to pay some of its subcontractors in full and those subcontractors complained to the project owner. Accordingly, the owner and debtor agreed to issue joint checks to the subcontractors. A payment was made by the owner to the debtor and a subcontractor by joint check within the 90 day preference period and the trustee subsequently sought to avoid the payment. The subcontractor argued that the payment was not a preference because the payment was by joint check and the debtor had insufficient interest in the funds to constitute property of the estate, citing the majority view. The *Code Elec.* court felt that the outside authority was factually distinguishable, but did not elaborate on the distinctions. The Court stated that the owner was not under any contractual obligation to pay the subcontractor directly and that the sole contractual payment obligation was to the debtor alone. The Court held that the fact that the check was issued jointly simply assured the owner that the subcontractor would be paid by the debtor which would operate to negate the subcontractor's lien rights on the project. The check was therefore a property interest of the debtor's when the debtor endorsed it over to the subcontractor within the preference period." So just be aware that minority views may be out there.

One other point to note about joint checks and preferences is to check the date of when the joint check agreement was entered into. The Court in *In re R.J. Patton Co., Inc.*, 348 B.R. 618, 624-25 (Bankr. D. Conn., 2006) noted that entering into a joint check agreement within the preference period could itself be a transfer of the debtor's interest in property rendering the agreement a nullity.

2. <u>Payments from Escrow or Funds Control Accounts</u>

Another common method of payment to claimants is payments from an escrow account established pre-petition by the principal and the surety pursuant to a Funds Control Agreement or a Financing Agreement.[15] Can such payments be deemed a preference? Payments from such accounts are typically covered by the earmarking doctrine. The earmarking doctrine is a judicially created equitable exception to the preference provisions of section 547. *In re EUA Power Corporation*, 147 B.R. 634, 640 (Bankr. D.N.H. 1992); *In re Neponset River Paper Company*, 231 B.R. 829 (1st Cir. BAP 1999); *In re Loggins*, 513 B.R. 682, 701 (Bankr. E.D. Tex. 2014). If the transferred funds were made available to the debtor for the sole express purpose of paying the debtor's obligation to a specific creditor then the debtor never had control of the funds. The payment is not a preference because the money was never subject to an equitable interest of the debtor and cannot be considered property of the estate under section 541. *In re EUA Power Corporation*, 147 B.R. 640; § 6.11; *5 Collier on Bankruptcy*, ¶ 547.03[2][a], Alan N. Resnick & Henry J. Sommers., 16th ed. 2017).

As noted by one Court, the test to determine if a preference has occurred is not what the creditor receives, but what the Debtor's estate has lost. *In re Loggins*, 513 B.R. 697. There can be no preference if the Debtor transfers property in which the debtor has no equitable interest. 513 B.R. 700. The earmarking doctrine is premised on the fact that funds provided to the Debtor to pay a specific indebtedness are not recoverable as a preference because the funds were never "property of the debtor," so the transfer does not disadvantage any creditor. 513 B.R. at 702. For

---

15 *See* the discussion on pages 866 to 871 of THE LAW OF PERFORMANCE BONDS, 2D ED., page 658 of the Law of Payment Bond Book, and pages 221-22 of the Surety/Bankruptcy Book.

the earmarking doctrine to apply, the Debtor cannot not have control or authority over the disposition of the funds. *See In re Bankvest Capital Corp.*, 374 B.R. 333, 344 (Bankr. S.D. Fla. 2007). It should be noted that, as a judicially created equitable exception, the application of the earmarking doctrine will be narrowly construed. *In re Loggins*, 513 B.R. 701.

(GEORGE)

B. <u>The Claimant Loses to the Trustee and Makes a Claim Against the Surety's Payment Bond</u>

Let's say that the Claimant, either through a settlement or in litigation with the trustee, loses the preference avoidance action, disgorges the payment, and then seeks recovery from the surety under the payment bond. There are a number of issues.

1. <u>Generally – Revival of a Claim under the RESTATEMENT OF SURETYSHIP (Section 70)</u>.

Initially, upon a principal's payment to its bonded project subcontractors and suppliers, a surety is discharged from the obligation to pay those same entities as Claimants under the payment bond. The principal's subcontractors and suppliers are not entitled to be paid twice.

But what happens if the principal's trustee in bankruptcy requires those subcontractors and suppliers to disgorge the principal's pre-petition payments as preferences? Those subcontractors and suppliers are now, effectively, unpaid. Can they now become Claimants against the surety's payment bond notwithstanding the prior "discharge" of the surety due to the principal's pre-petition payments? Namely, can their claims be revived?

Section 70 of the RESTATEMENT OF SURETYSHIP and its comments provide support for the revival of the Claimants' claims against the surety and the payment bond under these circumstances.[16] When the Claimants must return a pre-petition payment to the trustee as a preference, the Claimants are now "unpaid." Part of the theory is that the Claimants would not accept the payments from the principal, especially if the principal is in financial distress, and would first look to the surety for payment instead. That situation could require the surety to be involved in every payment made by a principal who may be in financial trouble. None of us in the surety industry want this to happen. The surety would prefer that the principal pay the Claimants and then we take our chances that the surety will be discharged from any further obligation to pay the Claimants.

There are a number of cases that support the revival of the Claimants' claims against the surety's payment bond which are cited in the presentation paper.[17]

---

[16] *See* **<u>Attachment A</u>** to this presentation paper for the relevant language and a comment.

[17] *See* Schexnayder, *Ch. 12*, *Bankruptcy, in* THE LAW OF PAYMENT BONDS, 2D ED, pages 651-652, footnote 33, for cases concerning when payments set aside as preferences do not discharge the surety. *See also* James D. Ferrucci and Frank M. Lanak, *The Surety's Right/Need to Retain Collateral after Release of Bond Liability: Revival of Surety's Liability and Avoiding Bankruptcy Pitfalls*, pages 2-8 (unpublished paper submitted at the Twentieth Annual Northeast Surety and Fidelity Claims Conference, September 24-25, 2009).

The surety may have defenses to the Claimants' revived claims, and Mike will address those defenses next.

(MIKE)

Okay, so the claimant has just been forced to disgorge a payment that it received over two years ago and it is now knocking on the surety's door looking to get paid under the payment bond. There are a number of possible defenses to consider, such as: (1) lack of timely notice; (2) release and/or (3) statute of limitations.

2. Potential Defenses to the Revived Claim

a. Notice Defense – The payment bond language and/or the terms of the applicable statute generally require that a claimant provide notice of its claim to the surety, identifying such information as for whom the work was furnished, the project, the dates the work was furnished and the amount owed. There are numerous cases holding that the failure to give timely and proper notice is a bar to a payment bond claim. But in this scenario, the claimant was paid all those years ago and at that time there was no need for the claimant to provide notice of its claim, because the claim was paid. Can lack of notice be argued as a defense in this situation? The tolling provisions of the Code (11 USC §108), as they relate to claims by parties other than the Debtor, are only operative where the automatic stay precludes parties from exercising their claims. However, the automatic stay generally does not preclude a third party from pursuing a claim under the debtor's payment bond. Therefore, the notice and limitations periods for asserting payment bond claims generally will not be tolled by a principal's bankruptcy filing. *See United States ex rel. American Bank v. C.I.T. Construction, Inc.*, 944 F.2d 253 (5th Cir. 1991); *Cumberland Metals, Inc. v. Kentucky Insurance Guarantee Assoc.*, 801 S.W.2d 339 (Ky. App. 1990); *Fountain Sand v. Chilton Construction Co.*, 578 P.2d 664 (Colo. App. 1978).

In *St Paul Fire and Marine Insurance Company v Century Asphalt Materials, LLC*, 2007 WL 1468549 (S.D. Tex. 2007), the payment made to a subcontractor by the principal was set aside as a violation of §549 of the Bankruptcy Code (unauthorized post-petition transfer). The subcontractor then filed suit against the surety and the surety moved for summary judgment contending that the subcontractor's claim was barred for failing to provide timely notice. The bankruptcy court, invoking equitable estoppel, held that the failure to provide notice was not a defense and it permitted the claimant to pursue its payment bond claim. The United States District Court for the Southern District of Texas reversed, holding that equitable estoppel was inapplicable because the notice requirement was a substantive condition precedent to maintaining a claim on a payment bond.

b. Release Defense – In the course of receiving payments, a claimant will typically execute a release of all of its claims, known or unknown, including claims against the surety. If subsequently the claimant is forced to disgorge a payment as a preference, can the surety use the release as a defense to the claimant's later claim against the payment bond?

In *Kimball Construction Co. v. XL Specialty Insurance Company*, 2016 U.S. Dist. LEXIS 143793 (D.Md. October 18, 2016), the principal entered into subcontracts on three projects with a subcontractor. The principal made payments to the subcontractor on the jobs in the spring of 2014 and then filed a Chapter 7 bankruptcy in July 2014. In December 2014, the surety made payments under its payment bonds on the three projects to the subcontractor. The surety obtained releases from the subcontractor in return for the payments. A year later, the trustee asserted a preference action against the subcontractor for the payments made by the principal. The subcontractor then sued the surety claiming that the surety may ultimately be liable for any amounts that it is compelled to pay the trustee, claiming unjust enrichment. The surety filed a motion for summary judgment arguing that the releases precluded any subsequent claims under the bonds.

The court held that the language in the releases was unambiguous and that there was no mutual mistake. The court noted the fact that the bankruptcy action was filed prior to the execution of the releases, and believed that the subcontractor could have contemplated the possibility of future preference actions. The court held that the surety would not be liable for claims related to the preference payments because of the releases. The court granted the surety's motion for summary judgment.

Similarly, in *In re Contractor Tech., Ltd,* 376 B.R. 156 (S.D. Tex. 2007), in this case, the principal filed bankruptcy before completing the project and the surety took over. The surety entered into a ratification agreement with the subcontractor and paid the full amount of the agreement. The ratification agreement provided that when the surety paid the full amount due, the subcontractor "fully and forever releases and discharges [surety] from any and all claims, suits and actions arising against the Payment Bond for all labor and/or materials furnished to date." The trustee subsequently asserted an avoidance action and the subcontractor was forced to disgorge prior payments the principal made. The Court stated that the claimant had knowledge of the pending bankruptcy and could have anticipated potential preference actions when it executed the release. Thus, the court ruled that there was no mutual mistake or failure of consideration.

In *In re SNTL Corp.,* 571 F.3d 826 (9^{th} Cir. 2009), the release signed by the claimant had a provision that permitted the survival of the claim if a subsequent preference action was filed against the claimant. The Court upheld the provision against a guarantor and, cited the Restatement, noting that under the general rule that guarantors must make good on their guaranties following avoidance of payments previously made by their principal debtors.

Reliance on a release is a fact intensive defense and factors such as when the release was entered into and the terms of the release must be considered.

c. <u>Statute of Limitations Issues</u> – Under the same scenario, when the claimant asserts its payment bond claim after being forced to disgorge prior payments, can the surety assert the statute of limitations as a defense? The Miller Act and the various Little Miller Act statutes and many payment bond forms have a short limitations period of one year in which to file suit. However, under the Bankruptcy Code the trustee has a minimum of two years to assert preference actions. Thus, a claimant could be forced to disgorge prior payments it received several years after the applicable statute or contractual limitations period has expired to assert a claim on the payment bond. We have found no cases directly on point.

(GEORGE)

V. <u>The Trustee's Direct Claim Against the Surety – an "Indirect Preference Action."</u>

The trustee may by-pass a preference claim against a Claimant and sue the surety directly under the theory that the surety is the true beneficiary of the principal's pre-petition payment to the Claimant because the surety would otherwise have had liability to the Claimant under the payment bond.[18] Even though the surety has not received any direct payments or transfers from the principal, the surety may be liable for a preference based upon the principal's pre-petition payment to the Claimant.

The case law under Section 547 has established that a payment by the Debtor of a guaranteed obligation is a payment that is to or for the benefit of the guarantor creditor.[19] A surety issues bonds for the principal with reimbursement rights against the principal in the event of losses under the bonds, and is therefore a "creditor" of the principal. When the principal makes a pre-petition payment to a Claimant, thereby releasing and discharging the surety from paying that obligation under the payment bond, the surety is receiving a benefit as a "creditor" of the principal under Section 547(b)(1). Absent a defense, the surety may be liable for the preference even though it never received the actual transfer of property from the principal.[20]

The surety may raise all of the defenses that the Claimant could have raised to the preference claim, including the failure of the trustee to prove each element of a preference under Section 547(b). A primary defense is that the transfer did not involve property of the bankruptcy estate, such as the trust fund and earmarking arguments that Mike has discussed. The surety also has the Claimants' affirmative defenses under Section 547(c) such as a contemporaneous

---

[18] The concept that the surety is the beneficiary of the principal's pre-petition payment to the Claimant is different from the concept that the surety may be a transferee of the property (the initial transferee or any immediate or mediate transferee of such initial transfer under Section 550 of the Bankruptcy Code) because, in the situation that we are addressing, <u>the surety never receives any transfer of the principal's property</u>. The surety only receives the benefit of the principal's transfer to a third party, the Claimant. The surety never has possession of any transferred property from the principal to the Claimant.

Section 550(a) of the Bankruptcy Code provides that under Section 547 (among others) that "the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from –

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
(2) any immediate or mediate transferee of such initial transferee.

Pursuant to Section 550(d) of the Bankruptcy Code, the trustee is only entitled to one recovery or satisfaction of the preferential transfer under Section 550(a), either from the initial transferee or the immediate transferee after the initial transfer. Since the surety never had the principal's transferred property, and was not the intended entity for whose benefit such transfer was made, the surety may have defenses to liability as a "transferee" under Section 550(a).

[19] *See* Schexnayder, *Ch. 12, Bankruptcy, in* THE LAW OF PAYMENT BONDS, 2D ED, pages 654-655, footnotes 38, 39 and 40.

[20] Newbury Corp. v. Fireman's Fund Ins. Co., 106 B.R. 186, 187 (D. Ariz. 1989).

exchange for new value, an ordinary course of business payment, or the Claimants providing advances of new value.[21]

Furthermore, the surety has its own Section 547(c) defenses based upon the surety's equitable lien rights or subrogation rights in the bonded contract funds. Specifically, a surety has subrogation rights to the bonded contract funds in the event that a principal fails to pay the Claimants on a bonded project. The surety's argument is that IF the principal pays its subcontractor and supplier Claimants, the surety's subrogation rights in the bonded contract funds are "released," and the principal may be entitled to the bonded contract funds. Cases have held that the principal's payment to the Claimants releases the surety's subrogation rights to the bonded contract funds, which constitutes "a contemporaneous exchange for new value" to the principal, and is a surety's defense under Section 547(c)(1).[22]

However, it is not easy just contending that because there are bonded contract funds that are no longer subject to the surety's subrogation rights, the principal's payments to its subcontractors and suppliers lets the surety off the hook. The cases seem to divide along a number of lines.

1. First, regardless of the amount of the principal's pre-petition payments to its subcontractors and suppliers, if there are bonded contract funds available in any amount, the release of the surety's subrogation rights in those bonded contract funds may be enough for the contemporaneous exchange for new value defense.[23]

2. However, if the principal <u>eventually</u> receives the bonded contract funds because it has paid the Claimants, that receipt may not be contemporaneous with the principal's payments to its subcontractors and suppliers, and the surety's release of its subrogation rights may not be deemed to be a contemporaneous exchange for new value.[24]

3. Third, there may be a relationship between the amount of the principal's pre-petition payments to the principal's subcontractors and suppliers versus the amount of the bonded contract funds subject to the surety's subrogation rights. Courts differ on this issue:[25]

   a. Some courts hold that there is no valuation requirement in Section 547 requiring the calculation of the bonded contract funds available and released compared to the principal's pre-petition payments;[26]
   b. Some courts hold that the release of the surety's lien and subrogation rights in the bonded contract funds alone is new value; and
   c. Some courts require an analysis, calculation and measurement of the amount of the new value the surety gives to the principal (the amount of the bonded contract funds

---

21 *See* Schexnayder, *Ch. 12, Bankruptcy, in* THE LAW OF PAYMENT BONDS, 2D ED, pages 655-673.

22 *In re* E. R. Fegert, Inc., 88 B.R. 258 (9th Cir. BAP 1988), *aff'd*, 887 F.2d 955 (9th Cir. 1989). *See also* Schexnayder, *Ch. 12, Bankruptcy, in* THE LAW OF PAYMENT BONDS, 2D ED, page 653 (footnote 36) and pages 660-667.

23 *In re* Dick Henley, Inc., 38 B.R. 210 (Bankr. M.D. La. 1984).

24 United Rentals Incorporated v. Angell, 592 F.3d 525 (4th Cir. 2010), *cert. denied*, 131 S. Ct. 121 (2010).

25 *See* Schexnayder, *Ch. 12, Bankruptcy, in* THE LAW OF PAYMENT BONDS, 2D ED, pages 663-

26 *In re* George Rodman, Inc., 792 F.2d 125 (10th Cir. 1986).

released from the surety's subrogation rights) and whether it is equal to or greater than the principal's alleged pre-petition preferential transfers.[27]

In summary, these are tough cases for a surety that revolve around the facts of the case. While there is authority that any release of the surety's subrogation rights in the bonded contract funds is a complete defense to the surety, there is also substantial authority that the surety's defense to the preference action will be limited to the actual value of the subrogation rights that the surety releases in the bonded contract funds.

VI. Summary and Conclusions: How the Surety May Avoid Preference Liability in a Principal's Bankruptcy Case

To quickly summarize what we have covered in our two presentations in November and today concerning preferences in bankruptcy and what a surety may do to avoid preference liability.

When the surety receives a direct transfer from the principal, the surety should seek the payment or collateral up front as a "contemporaneous exchange for new value" at the time that the surety executes the bonds for the principal. This is not always possible. The principal's transfer to the surety may well achieve all of the elements of a preference – a transfer of the Debtor's property to the surety as a creditor for an antecedent debt made while the Debtor was insolvent. Whether this occurs as a result of a demand for collateral, a judgment, a voluntary transfer, or otherwise, the transfer is voidable for 90 days if the principal files a bankruptcy case.

Regardless, the old adage is accurate – take the payment or the transfer and hope for the 90 days to pass. The only thing that the surety may lose is the collateral it got.

As we discussed today, indirect transfers that result in a benefit to a surety are more difficult because the surety has no control over the facts – what occurs and when. What appears to be, and may actually be, an ordinary course of business payment from a principal to a third-party can result in the surety's exposure to preference liability.

There is one way in a bankruptcy case that a surety may avoid preference liability, and that is to finance the principal, now the Debtor or Debtor-in-possession, in its bankruptcy case. We understand that "financing" is a four-letter word in the surety industry, especially when the principal has already filed a bankruptcy case. However, there are creative ways for a surety to protect itself from ANY preference liability – direct and indirect – through post-petition financing of the Debtor. If you find yourself in this situation, and financing a Debtor in bankruptcy appears to be the best performance option, we can help with a creative solution to the preference issues.

---

[27] Newbury Corp. v. Fireman's Fund Ins. Co., 106 B.R. 186 (D. Ariz. 1989); *In re* E. R. Fegert, Inc., 88 B.R. 258 (9th Cir. BAP 1988), *aff'd*, 887 F.2d 955 (9th Cir. 1989); *In re* Gem Construction Corp. of Va., 262 B.R. 638 (Bankr. E.D. Va. 2000).

Attachment A

Revival of a Claim under Section 70 of the RESTATEMENT OF SURETYSHIP

Section 70 of the RESTATEMENT OF SURETYSHIP provides:

§ 70. When Obligation of Secondary Obligor Revives

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

In general terms, if the principal (the principal obligor) pays the Claimant subcontractor (the obligee), the Claimant is only entitled to that one performance (the principal's payment) and the surety (the secondary obligor) is discharged from making a second payment to the Claimant. However, if the principal's payment to the Claimant is later set aside, and the Claimant would then have had a claim against the surety because of the principal's failure to pay the Claimant, the Claimant's claim against the surety revives in order for the Claimant to then make its claim against the surety.

Comment *b*. to Section 70 states:

> *b.* *Preferences.* The principle embodied in this section has its most common application in the law of preferences. When an obligee receives a payment from an insolvent obligor, and, because the payment is later held to constitute a preference, the obligee must return the payment or its value to the bankruptcy trustee, the obligee is put into the same position as though the payment had never been made. Therefore, this section revives the obligee's claims against the secondary obligor. If this were not the case, and the claim against the secondary obligor, having been discharged by the principal obligor's payment, did not revive, the result would not necessarily be favorable to secondary obligors. After all, an obligee would be reluctant to accept payment from a financially distressed principal obligor when there is available an action against a solvent secondary obligor because, if the payment later were held preferential, the obligee would have no recourse against the secondary obligor. To avoid such an inopportune situation, the obligee would have a strong incentive to proceed initially against the secondary obligor rather than accept payment from the principal obligor. As a result, in the absence of the rule set forth in this section, secondary obligors might well be called upon to perform more often rather than less often.