SURETY TODAY PRESENTATION
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BANKRUPTCY PREFERENCES – THE SURETY'S DIRECT EXPOSURE FOR PREFERENTIAL TRANSFERS

(GEORGE)

I. Introduction

A surety facing the Debtor's or the trustee's complaint to avoid a preferential transfer in the Debtor's bankruptcy case is the very definition of "going backwards" – you thought that you were in one place and now you are not. You thought that you had the money in hand and the exposure was gone. Now, the Debtor or the trustee wants that money back and that may rekindle the surety's exposure to loss.

There are essentially two situations when the surety may be "going backwards:"

1. First, when the surety receives a direct transfer of the principal's property, whether as collateral or some other transfer, payment or reimbursement, but then the principal files a bankruptcy case.
2. Second, when the surety receives the benefit of an indirect transfer of the principal's property to a third party. For example, the principal pays someone other than the surety, such as its subcontractors and suppliers, thereby apparently relieving the surety of its payment obligations under the payment bond, but then the principal files a bankruptcy case.

There are many nuances to these situations, which are some of the most complex and knotty factual and legal problems for a surety to solve. We can't cover the issues in only one 30-minute presentation. As a result, there will be two presentations – today's presentation concerning direct preferential transfers to a surety and the possible outcomes, and on December 10, 2018, a presentation concerning the more difficult issues that arise when a surety receives an indirect preferential transfer due to the principal's payment to some third party.

(MIKE)

II. Preferences Under the Bankruptcy Code – Generally

Under the bankruptcy preference powers, a trustee or debtor in possession ("DIP") is able to reach back in time, prior to the bankruptcy filing, and void, undo or set aside certain transfers of the debtor's assets. The Bankruptcy Code at 11 U.S.C. §547 establishes the power of a bankruptcy trustee or DIP to assert a preference action with respect to certain transfers that occur within a specific time period prior to the filing of a bankruptcy. In general, a "preference" exists

when a person or entity makes payment or other transfers to certain creditors and not to others prior to a bankruptcy filing. Such favoritism or preferential treatment in close proximity to the filing of bankruptcy is prohibited by the Bankruptcy Code. *Kenan v. Fort Worth Pipe Co.,* 792 F.2d 125, 127 (10th Cir. 1986); *Sigmon v. Royal Cake Co.*, 13 F.3d 818 (4th Cir. 1994)(purpose of section 547 is to prevent favoritism among creditors who should stand on equal footing.).

The bankruptcy preference powers have two primary purposes:

(1) to promote the bankruptcy policy of equality of distribution among creditors by ensuring that all creditors of the same class will receive the same pro rata distribution share of debtor's estate, and
(2) to reduce creditors' incentive to rush to dismember a financially unstable debtor by providing for the recapture of last-minute payments to such creditors. *Matter of Smith*, 966 F.2d 1527 (7th Cir. 1992), *certiorari dismissed* 113 S.Ct. 683, 506 U.S. 1030, 121 L.Ed.2d 604; *Butler v. David Shaw, Inc.*, 72 F.3d 437 (4th Cir. 1996).

The preference powers are designed to help creditors by allowing the avoidance of transfers that favor certain "preferred" creditors and enables the bankruptcy estate to recover those assets for equitable distribution to all the creditors. *In re Hechinger Inv. Co. of Delaware, Inc.*, 288 B.R. 398 (Bkrtcy.D.Del. 2003). Thus, the preference powers put all creditors on a relatively level playing field with respect to use of a debtor's assets that may have been available prior to bankruptcy and "during the debtor's slide into bankruptcy." *In re Keller Tool Corp.*, 151 B.R. 912 (Bkrtcy.E.D. Mo. 1993).

(GEORGE)

III. The 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 <u>transfer</u>[1] of an interest of the debtor in <u>property</u>[2] –

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

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[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.

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, as Mike will discuss, a preference is "voidable," not automatically "void." Second, the "transfer" definition is very broad and includes both a debtor's voluntary or 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."[7] 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.

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[5] *See* Section 101(32) of the Bankruptcy Code and relevant case law for the definition of "insolvent." *See also* Section 547(f) of the Bankruptcy Code, footnote 7 below.

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

[7] *See* 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."

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. This example goes to the heart of Mike's earlier discussion of "equality of distribution" among like creditors.

(MIKE)

IV. Preferences Under the Bankruptcy Code – Procedural

a. Intent Not Required

It should be noted that in establishing the elements of a preference action, the Debtor's or creditor's intent or motive is not material. *Perma Pacific Properties*, 983 F.2d 964 (10th Cir. 1992). It is the effect of the transaction, rather than the Debtor's or creditor's intent, that is controlling. The Court in *In re Messenger*, 166 B.R. 631 (Bkrtcy.M.D. Tenn. 1994) observed that the "[p]reference statute is blind to intent or default; enactment of the Bankruptcy Code removed any scienter requirement for preference recovery and knowledge or intent of the creditor is irrelevant in determining whether an avoidable transfer occurred."

b. Statute of Limitations

The Bankruptcy Code at section 546(a) provides that a preference action must be commenced within 2 years after the entry of the order for relief or 1 year after the appointment or election of the first trustee in a chapter 7 or chapter 11 bankruptcy case, if such appointment occurs within the 2 year period after the entry of the order for relief. The "order for relief" in this context means the date that the bankruptcy petition in a voluntary bankruptcy case was filed. The time of appointment of a trustee varies depending on the chapter. In chapter 7 bankruptcies, the trustee is appointed when the permanent trustee is elected at the meeting of creditors or automatically at the meeting if no election is held. Under chapter 11, a trustee is appointed when the court signs the order approving the appointment of the trustee.

While a trustee or DIP must file a preference action within the limitations period to obtain affirmative relief, the preference powers may be used defensively outside of the limitations period to contest the validity of liens or claims against the bankruptcy estate.

c. Nature of a Preference Action

Under Bankruptcy Rule 7001(1) the trustee or DIP must file an Adversary Proceeding to initiate a preference action. This means that an adversary complaint must be filed, a summons must be issued and served. A preference action may not be initiated as a motion.

d. Preferential Transfers are Voidable

Preferential transfers are not automatically "void," but rather are "voidable," which means that the trustee or DIP must affirmatively file an avoidance action.

e. **Burden of Proof**

For the purposes of a preference action, the trustee has the burden of proving the avoidability of a transfer by establishing each and every element of a preference by a preponderance of the evidence. The creditor against whom recovery or avoidance is sought has the burden of proving any applicable defense by a preponderance of the evidence. *See* Section 547(g).

V. The Surety's Defenses to a Preference Avoidance Action.

a. <u>Defenses Based Upon the Elements</u>

A surety's potential defenses to a preference action can initially be found in the elements of a preference action itself. In order to prevail on a preference action, the trustee or DIP must establish each and every element of a voidable preference under the Bankruptcy Code. *In re Ralar Distributors, Inc.,* 4 F.3d 62 (1st Cir. 1993). While any of the elements could potentially be challenged as a defense, one element bears mentioning in the surety context i.e.: the requirement that the transfer be of property of the Debtor. As George noted, an essential element of proof for a preference action includes establishing that the Debtor had an "interest in the property transferred" under Section 541 of the Bankruptcy Code. Thus, an initial defense can be raised challenging whether property of the estate was involved in the transfer. For example, if a payment was made by the Debtor within 90 days of the bankruptcy and all of the other elements were present, if the funds paid were held in trust by the Debtor, a preference action could not be maintained. As we have discussed in prior Surety Today presentations, trust funds are common in the construction industry by statute, contract or in the GAI. When a trust exists, the Debtor holds the trust funds as a mere trustee and such interest is not property of the bankruptcy estate under section 541 of the Code. In *In re IT Group, Inc.,* 326 B.R. 270 (Bkrtcy. D.Del. 2005) the Chapter 11 Debtor, in its capacity as prime contractor on construction projects, held funds in trust for the benefit of unpaid subcontractors pursuant to provisions of New York lien law. Under the lien law the funds did not constitute an "interest of the debtor in property;" accordingly, the Debtor's prepetition transfers of such funds to subcontractors were not avoidable as preferences.

b. <u>Statutory Defenses to a Preference Avoidance Action – Section 547(c)</u>.

Even when the trustee satisfies all of the elements of a preference action, the transfer may not be avoided as a preference if the creditor can prove that it is entitled to rely on one of the exceptions listed in section 547(c). As noted earlier, the creditor has the burden of establishing the elements of such exceptions or defenses. Section 547(c) lists 7 exceptions that may be used as defenses, however, the exceptions that are the most common and valuable to a surety are the following:

1. **Section 547(c)(1) – A Contemporaneous Exchange for New Value**.

Section 547(c)(1) provides the so-called "new value" defense and 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, and there was in fact a contemporaneous exchange. A good example of this defense would be where the Debtor pays COD in exchange for a shipment of materials for a project. In that scenario you essentially have a simultaneous exchange of goods for payment. The new value defense "is grounded in the principle that the transfer of new value to the debtor will offset the payments, 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). Thus, for this defense to apply, the value given for the transfer must actually enhance the worth of the Debtor's estate so as to offset the reduction in the estate caused by the transfer. *Id. In re JWJ Contracting Co., Inc.*, 287 B.R. 501, 506 (B.A.P. 9th Cir. 2002), *aff'd*, 371 F.3d 1079 (9th Cir. 2004). 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.

In order to establish the defense, it must first be established that new value was provided. "New value" is defined in the Bankruptcy Code as:

> money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation.

Section 547(a)(2).

New value is measured at the time of the transfer. A promise to provide future goods and services in exchange for payment cannot constitute new value at the time of the transfer. *In re Modtech Holdings, Inc.*, 503 B.R. 737, 747 (Bankr. C.D. Cal. 2013). The Tenth Circuit 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) of the Code. *In re Maxwell Newspapers, Inc.,* 192 B.R. 633, 637 (Bankr.S.D.N.Y.1996).

In determining new value, a court must measure "the value given to the debtor in determining the extent to which the trustee may void a contemporaneous exchange." *Sulmeyer v. Suzuki (In re Grand Chevrolet, Inc.),* 25 F.3d 728, 733 (9th Cir.1994). Thus, if the Debtor received $30,000 in materials, but paid $50,000, $30,000 for the goods and another $20,000 on prior shipments, there would still be a $20,000 preference, because the extent of the new value to the estate was only $30,000, not the entire $50,000 paid. 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) has held that the release of a fully secured lien in exchange for payment from the Debtor would constitute new value.

If new value can be established, in order to prove the defense, the exchange of the new value must in fact be substantially "contemporaneous." Some courts have adopted a bright line 10-day rule for determining if the exchange was contemporaneous. Under this rule, if the transaction was not completed within 10 days, it was not contemporaneous. Other courts employ a case by case approach and look to the facts and circumstances to determine if the exchange was contemporaneous – things such as: length of delay, reason for the delay, complexity of the transaction, intent of the parties, risk of fraud, etc. are considered. Under this approach, a two to three week delay in an exchange has been held to be contemporaneous.

Finally, to establish the new value defense, the parties must have intended the transaction to be contemporaneous. Even if the transaction on its face appears to be contemporaneous, if the parties did not intend for the exchange of new value to be contemporaneous, the defense will fail.

2. Section 547(c)(2) - Transfers in the Ordinary Course

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. It is designed to induce creditors to continue to deal with a distressed entity.

To establish the ordinary course defense, the creditor must first prove that the underlying debt on which payment was made was incurred by the Debtor in the ordinary course of business or financial affairs of BOTH the Debtor and the creditor. This analysis requires the court to examine the "normality" of incurring the debt at issue in each party's business operations generally. If the transaction from which the debt arose was not ordinary for both parties, then the defense will fail. 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. In analyzing this aspect of the defense, the court will engage in a subjective, factual analysis. The controlling issue is whether the transactions both before and during the 90 day period were consistent. Even if the payments were irregular, they may still be considered ordinary if they were consistent with the course of dealing between the particular parties. Thus, it becomes important to establish a baseline of dealing between the parties during a time period when the debtor's day to day operations were ordinary, preferably before the debtor became financially distressed. The court will then compare those dealings with the dealings in the 90 day preference period. Factors the court will examine include: (1) length of time the parties were engaged in the type of dealing at issue; (2)

whether the amount or form of payment differed; (3) whether any unusual collection or payment activities occurred; and (4) the circumstances under which payment was made.

With respect to the alternative prong of the defense, it may be proven that the transfer was made according to ordinary business terms in general. This prong creates an objective standard according to norms in the specific industry and will typically require some expert testimony.

3. <u>Section 547 (c)(4) – Transfer for Subsequent Advances</u>.

Section 547(c)(4) provides that a transfer may not be avoided as a preference if the transfer was made to or for the benefit of a creditor to the extent that after such transfer the creditor gave new value to or for the benefit of the debtor that is not secured by an otherwise unavoidable security interest and on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor. Thus, from the Code 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).

This defense is premised on the theory that to the extent unsecured new value is given to the debtor after a preferential transfer is made, the preference is repaid to the bankruptcy estate. *In re Prescott,* 805 F.2d 719 (7th Cir. 1986). The Debtor's assets have not been depleted to the disadvantage of other creditors, when a creditor advances new value. *Jones Truck Lines, Inc. v. Full Serv. Leasing Corp.,* 83 F.3d 253, 257 (8th Cir. 1996). This defense is intended to remove the unfairness of voiding transfers without giving corresponding credit for subsequent advances of new value.

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VI. Situations in Which the Surety Receives a Direct Preference

The surety may receive a direct preference in several ways.

A. The surety receives payment of the bond premium.

Yes, the surety may receive a preferential transfer when the principal pays the bond premium unless one of the defenses to a preference is available.

The bond premium may be paid at any number of times: (a) some sureties require the premium to be paid prior to or contemporaneously with the execution and delivery of the bond; (b) some sureties require payment within a specified period of time, such as 45 days after the execution and delivery of the bond; (c) some sureties are willing to wait until after the obligee pays the principal the bond premium in the principal's first payment application; and (d) some sureties may allow even greater flexibility for bond premium payments.

The two most obvious preference defenses in this situation are:

1. A contemporaneous exchange for new value – the value is the surety's execution of the bond in return for the payment of the premium. But, as Mike has described previously, a "contemporaneous exchange" means "contemporaneous," and most of the payment options that I described previously, other than the first one, are not necessarily "contemporaneous."

2. A payment in the ordinary course of business. However, the "flexibility" of some sureties for when the premium payment is made, and whether the payment meets the "ordinary course of business" or "ordinary business terms" standards, may make this defense difficult for a surety to maintain or prove. This defense may be available for more of the payment options that I described previously if they are truly "ordinary" payments.

In summary, a surety's execution and delivery of a bond prior to receiving a payment for the bond premium may result in a claim for a preferential transfer. I have faced this situation before so I know that it can occur.

B. The surety may receive a voluntary transfer of the principal's real and/or personal property.

1. A surety may receive collateral at the inception of the surety's bond program for the Debtor, and prior to or contemporaneously with the bonds being executed – and the contemporaneous exchange for new value defense will be effective for this transfer of collateral. This situation would not result in a preferential transfer.

2. A surety may execute some prior bonds, but then may require and receive collateral before the surety's execution and provision of new and additional bonds. Then, within 90 days of the surety's receipt of the collateral, the Debtor files its bankruptcy case. Whether or not there were actual claims against the prior bonds, those prior bonds are an "antecedent debt" of the Debtor under the definitions of "debt" and "claim." To the extent that the surety wishes to use the collateral to reimburse itself for losses on the bonds executed prior to its receipt of the collateral, the surety may have received a voidable preference. However, to the extent that the surety may have losses on the new bonds issued in reliance upon the receipt of the collateral, the surety should not have a preferential transfer because of the new value provided to the Debtor with the issuance of the new and additional bonds.

3. A surety may make a demand for collateral or demand to be placed in funds due to actual or anticipated claims and/or losses on bonds executed prior to the Debtor's

filing of its bankruptcy case. To the extent that the surety receives the transfer of the collateral within 90 days of the filing of the Debtor's bankruptcy case, there is really no defense to the avoidance of the preferential transfer.

4. Question: Are the surety's pre-petition financing agreement rights against the principal, including the receipt of collateral, an avoidable preferential transfer if the principal files for bankruptcy within ninety days of the financing agreement's execution and implementation?

Some performance bonds may provide the surety with the option to finance its principal as the surety's performance under the performance bond, or the surety may decide to finance its principal anyway as a business decision to mitigate potential loss. Most indemnity agreements provide that the surety may finance the principal, with any funding becoming a loss for which the surety is entitled to be reimbursed. And, under most financing agreements, the surety obtains whatever collateral the principal may have to secure the surety for those potential losses as well as trust fund rights to the bonded contract funds.

Notwithstanding the surety's financial assistance, the principal may file a bankruptcy case less than 90 after the execution of the financing agreement and the surety has perfected its liens on the collateral. The question is whether the surety's financing provides "new value" to the principal, now the Debtor, and provides a defense to the surety's receipt of the collateral and any other rights.[8]

Unfortunately, under the definition of "new value" in Section 547(a)(2) of the Bankruptcy Code, the "new value" definition "does not include an obligation substituted for an existing obligation." Therefore, there may be a conflict between the surety's position and the trustee's position.

a. The surety's position is that it has the right, but not the obligation to finance the principal under the existing indemnity agreement or under the existing bonds, and that the surety's financing has provided new value and a benefit to the principal, including access to and use of the bonded contract funds as trust funds for the principal's performance of the work and payment of its subcontractors and suppliers. The surety may also argue that the effect of its financing will reduce the surety's eventual unsecured claim to the benefit of other unsecured creditors.
b. The trustee's position is that the performance and payment bonds are "existing obligations" for the surety, and that the surety's financing of the principal through the financing agreement is substituting one method for the performance of the surety's obligations under the bonds (the financing agreement) for the surety's already existing obligations for the performance of the work under the performance bond and the payment of the principal's subcontractors and suppliers under the payment bond.

The surety wants to preserve its trust fund control over the collection and use of the bonded contract funds and the collateral it obtained to secure the risk of financing the principal. Whether

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[8] *See* Chad Schexnayder and J. Blake Wilcox, *Ch. 14*, *Bankruptcy, in* THE LAW OF PERFORMANCE BONDS, 864-871 (Lawrence R. Moelmann, Matthew M. Horowitz & Kevin L. Lybeck eds., Am. Bar Ass'n, 2d ed. 2009).

a particular bankruptcy court will allow this to happen is, unfortunately, an open question based on a case by case assessment of the facts.

(MIKE)

C. The surety may receive an involuntary transfer of the principal's real and/or personal property.

1. Real property –

Some indemnity agreements authorize the surety to file a mortgage or deed of trust on the principal's property in the event of a default or as collateral security. Using the attorney-in-fact provision of the Indemnity Agreement a surety can even file the mortgage or deed of trust without the participation of the principal involuntarily. If the surety issues bonds and then at a later time decides to file a mortgage or deed of trust to secure itself, maybe because the principal's finances are not looking to good or because the surety has received payment bond claims or unfavorable status reports from obligees, and the principal filed for bankruptcy within 90 days of the recording of the mortgage or deed of trust, the prepetition establishment of a lien on the now Debtor's property would constitute a preference and could be avoided if all the other elements of a preference are met.

Section 101 of the Bankruptcy Code defines a "transfer" as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property...." *Id.* § 101(54). Sections 547(e)(2)(A) and (B) of the Bankruptcy Code further provide that a transfer is *made* 1) at the time the transfer takes effect between the parties if the transfer is perfected at or within ten days after such time; and 2) if perfection does not occur within ten days, then at the time of perfection. *Id.* § 547(e)(2). *In re Alexander*, 219 B.R. 255, 258 (Bankr. D. Minn. 1998). Since the right to record a mortgage was granted when the Indemnity Agreement was executed, it is the subsequent recording of the mortgage that is a potential preferential transfer.

2. Personal property

Most Indemnity Agreements provide that the agreement constitutes a security agreement under the UCC and when the Indemnity Agreement is filed with a UCC-1 financing statement a perfected security interest under Article 9 of the UCC is created in the designated personal property of the principal. In some instances a surety will automatically file the UCC-1 and obtain a security interest as a matter of course when the Indemnity Agreement is executed. In that case, if the bonds are issued contemporaneously there would not be a preferential transfer. If however, the surety waits to file is UCC financing statement until later, when claims start rolling in and a bankruptcy is filed within 90 days thereafter, a preference may exist. Under the Bankruptcy Code the granting of a security interest is a transfer within the definition of section 547. *Vogel v. Russell Transfer, Inc.*, 852 F.2d 797 (4th Cir. 1988). Similarly, the perfection of a security interest is also a "transfer of property" under the Code. *In re Phillips*, 24 B.R. 712 (Bkrtcy. E.D.Cal. 1982).

3. Judgment liens

In some cases, the surety incurs losses and is then able to obtain a judgment against the principal and the principal then files bankruptcy. The Bankruptcy Code definition of transfer is broad enough to include any judicial proceeding that fixes a lien upon property of the Debtor. *In re Burnham*, 12 B.R. 286 (Bkrtcy. N.D.Ga. 1981). Moreover, executions or garnishments on judgments, fall within the definition of a "transfer" under the Code. *In re Rocky Mountain Ethanol Systems, Inc.*, 21 B.R. 707 (Bkrtcy. D.N.M. 1981); *In re Conner*, 733 F.2d 1560 (11th Cir. 1984).

D. The surety may receive a letter of credit from a bank for an "antecedent debt," which letter of credit is secured by the principal's collateral.

As we have discussed in a prior Surety Today presentation,[9] a letter of credit and the proceeds of a letter of credit are not property of the Debtor's bankruptcy estate. Therefore, generally speaking the letter of credit itself and the proceeds from a letter a credit may not be the subject of a preference action because property of the Debtor are not involved. But, as we have also noted before, and will address again briefly next month, some courts have deemed a letter of credit an "indirect preference" to the surety. An indirect preference can be found where the Debtor's property, whether it is cash or other collateral, is pledged as collateral to the bank in exchange for the bank agreeing to issue a letter of credit to the surety. The collateral provided to the bank by the principal would constitute property of the estate. Some courts have found that in such a factual situation where the letter of credit and the principal's collateral supporting it was provided to secure an antecedent debt, and which meets the other criteria of being a preference, is essentially an indirect transfer of the principal's collateral to the surety through the bank. The courts have merely collapsed the three transactions into one transaction and ignore the independence principal.

VII. Conclusion

Preference actions allow a trustee or debtor in possession to go back in time and void transfers of the Debtor's property. Every surety must be familiar with the preference exposure and potential defenses even before a bankruptcy is filed.

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[9] *See* the Surety Today presentation on December 12, 2016.