SURETY TODAY PRESENTATION

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Bankruptcy: The Debtor's and the Surety's Rights to the Bonded Contract Funds

This is the second presentation in a series of surety/bankruptcy related presentations that George and I will give. As I mentioned last month, our Surety Law Group has extensive experience in the bankruptcy arena - having represented sureties in bankruptcy courts all over the country and having written and presented on the subject extensively.

Last month on November 13, 2017 we discussed:

1. The Automatic Stay – the stay of any actions against the Debtor or property of the Debtor's bankruptcy estate as of the filing of the Debtor's bankruptcy case. And we discussed . . .
2. The Property of the Debtor's bankruptcy estate – which is "comprised of all legal or equitable interests of the debtor in property as of the commencement of the bankruptcy case, wherever located and by whomever held."

Today's presentation is titled: *Bankruptcy - The Debtor's and the Surety's Rights to the Bonded Contract Funds*. Once a principal files a bankruptcy case and becomes a Debtor – what are the Debtor's and surety's rights to the Bonded Contract Funds? This is frequently one of the main battle grounds in bankruptcy, so we thought this was an important topic to address.

Of course, the Debtor or bankruptcy trustee will contend that the Bonded Contract Funds are property of the Debtor's bankruptcy estate and are subject to the automatic stay, which prevents the surety from taking control of and/or utilizing the contract funds. The Debtor may further contend that it can use the Bonded Contract Funds under Section 363 of the Bankruptcy Code because such funds constitute "cash collateral" in which the Debtor has an interest, and that the Bonded Contract Funds may be used pursuant to a bankruptcy court order.

The surety's rights to the Bonded Contract Funds can arise in a variety of ways –

- for example, through the General Agreement of Indemnity. Under the Indemnity Agreement, the Principal, now Debtor, has the obligation to hold the surety harmless for any performance and payment bonds executed by the surety, and to indemnify and reimburse the surety for any losses under the bonds and the indemnity agreement.
- The Surety's rights also arise by operation of law under its rights of equitable subrogation if the Debtor is in default under the bonded contract and the surety performs under its

bonds. The surety has the right and expectation that the contract funds, which are security or collateral for the surety's performance, will be used by the Debtor to perform the bonded contract and to pay the Debtor's subcontractors and suppliers.

- The surety may also have rights as a secured creditor if the surety timely perfected its security interest in the contract funds.

As will be discussed today, often times major problems arise with respect to the Bonded Contract Funds in the bankruptcy context because the debtor and/or trustee are simply unaware of or don't recognize that the surety has rights and interests in the Bonded Contract Funds. Accordingly, part of the surety's job in a bankruptcy is to make sure that all the parties – the debtor, trustee, secured creditors and especially the judge are aware of the surety's rights.

George will begin our discussion today by explaining the Structure and Effect of Section 363 of the Bankruptcy Code – the authorizing statute for the Debtor's Use of Cash Collateral, I will follow by discussing the Surety's defenses to the Debtor's 363 motion. George will then talk about what the surety should hope to accomplish with respect to the Bonded Contract Funds. Next, I will review some of the practical steps that the surety can take with respect to protecting its rights and interests in the Bonded Contract Funds. Finally, George will close with a brief discussion of the use of surety financing in bankruptcy as a means for the surety to obtain control over the Bonded Contract Funds.

What is the Effect and Structure of Section 363 of the Bankruptcy Code?

George: Section 363 of the Bankruptcy Code addresses the Debtor's "use, sale, or lease of property" of the Debtor's bankruptcy estate. The Debtor's use of property could be any of the Debtor's property, including equipment, inventory, materials, etc. The Debtor's use of property that we are addressing today concerns the Bonded Contract Funds from the contracts bonded by the surety, which may fall under the definition of "cash collateral" in Section 363.

Cash collateral means "cash" or "other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest" [Section 363(a)]. The Bonded Contract Funds are obviously "cash" or "cash equivalents" in which the Debtor asserts that it has an interest. Therefore, if both the Debtor and the surety have an interest in the Bonded Contract Funds, then the Bonded Contract Funds are "cash collateral" under Section 363 of the Bankruptcy Code.

Section 363 Structure and Procedures.[1]

[1] Section 363(c)(1) – provides that if the Debtor (or trustee) is authorized to operate its business under either Chapter 11 or Chapter 7, it "may use property of the estate in the ordinary course of business without notice or a hearing" (the Debtor is not required to obtain Bankruptcy Court approval).

1. Section 363(c)(2) – provides that it is the Debtor's duty to forebear from and not use "cash collateral" unless "(A) each entity that has an interest in such cash collateral consents; or (B) the court, after notice and a hearing, authorizes such use … in accordance with the provisions of" Section 363.

2. Section 363(e) – **furthermore**, "at any time, on request of an entity that has an interest in property used, … or proposed to be used, … by the [Debtor], the court, with or without a hearing, shall prohibit or condition such use, … as is necessary to provide adequate protection of such interest."

As a result, the surety may consent to the Debtor's use of the Bonded Contract Funds. Or the Debtor, pursuant to a Motion to Use Cash Collateral, or the surety, either in opposition to the Debtor's Motion or pursuant to the surety's own Motion to Prohibit the Debtor's Use of Cash Collateral, may go to the Bankruptcy Court for a determination as to whether the Debtor has the authority to use the Bonded Contract Funds. In that event:

Section 363(p) – provides that in any hearing on the Debtor's request to use cash collateral, namely the Bonded Contract Funds, **or** on the surety's opposition to the Debtor's use of the Bonded Contract Funds:

a. The entity asserting an interest in the Bonded Contract Funds, namely the surety, "has the burden of proof on the issues of the validity, priority or extent of such interest" that the surety has in the Bonded Contract Funds; and
b. The Debtor "has the burden of proof on the issue of adequate protection" to be provided to the surety for the Debtor's use of the Bonded Contract Funds.

Therefore, there are three issues to address:

A. **Issue #1** – The first issue is whether the Debtor has an interest in the Bonded Contract Funds. If not, then the Bonded Contract Funds may not be property of the Debtor's bankruptcy estate. Assuming, for the moment, that the Debtor has an interest in the Bonded Contract Funds, which then become property of the Debtor's bankruptcy estate, there are two other issues.

B. **Issue #2** – The second issue is whether the Debtor recognizes that the surety has an interest in the Bonded Contract Funds. Regardless, it is still the surety's burden of proof concerning the validity, priority or extent of the surety's interest in the Bonded Contract Funds.

Mike Stover will address the first two issues of whether either or both the Debtor and the surety have an interest in the Bonded Contract Funds, thereby making them "cash collateral" under Section 363. I will then address the third issue –

C. **Issue #3** – If the Bonded Contract Funds are "cash collateral," what is the adequate protection that a surety requires in order for the Debtor to be able to use the Bonded Contract Funds for its operations during its bankruptcy case?

What are the Surety's Defenses to the Debtor's 363 Motion?

Mike: Okay, so the Debtor has filed a motion under Section 363 of the Bankruptcy Code to use the Bonded Contract Funds as cash collateral. What are some of the defenses that the surety can assert in opposition to that motion:

1. **Property of the Estate** – The first defense may be that the Bonded Contract Funds are not property of the estate under the Bankruptcy Code. For Section 363 to be applicable, the property that is the subject of the Motion must be *property of the bankruptcy estate*. As George discussed last month, Section 541(a)(1) of the Bankruptcy Code provides that the filing of a petition in bankruptcy creates an estate which consists of "all legal or equitable interests of the debtor in property as of the commencement of the case." It is important to note that the bankruptcy estate under Section 541 succeeds only to those property interests that the Debtor had as of the date of the commencement of the bankruptcy case. Stated differently, "the filing of a bankruptcy case does not, and cannot, give a Debtor or its creditors greater rights in property than the Debtor had prior to bankruptcy." Bankruptcy law does not create property rights, rather the bankruptcy court will look to state law to determine if the Debtor has any valid property rights.

There are three primary arguments that a surety can typically assert to support a position that the Debtor's Section 363 Motion should be denied because the Bonded Contract Funds are not property of the estate.

a. **Debtor is in Default** – Most courts recognize the basic rule of law that when a party defaults under its contract, the defaulting party is not entitled to any further payments under that contract. This is so because when the Debtor is in default, the obligee is entitled to withhold all funds and payments under the terms of the bonded contract and to use such funds to complete the bonded project. Thus, the Debtor has no interest in or entitlement to the remaining contract funds, including retainage, on the bonded projects. Because the Debtor has no interest in or entitlement to the remaining contract funds, such funds are not property of the estate under the Bankruptcy Code.

The Third Circuit recognized this concept *In re Modular Structures, Inc.*, 27 F.3d 72 (3rd Cir. 1994), where the Court held that "[w]e conclude that, based upon the record currently available in the present case, Modular breached its contractual obligation to pay its subcontractors and was therefore not 'owed' the monies held by the obligee. Under those circumstances, those funds are not properly considered part of the estate in bankruptcy." *Id.*, 27 F.3d at 80.

b. **Trust Fund Rights** – The second argument to assert is that the Bonded Contract Funds are trust funds. The creation of a trust alters title or ownership of the trust property. Instead of the principal having total and complete ownership over the Bonded Contract Funds, upon creation of a trust regarding such funds, the principal becomes a mere trustee with only bare "legal" title, and the beneficiaries of the trust - the surety, the subs, the suppliers - become the "equitable" owners of the Bonded Contract Funds in trust. On November 14, 2016, Lou Kozlakowski and I discussed trust funds in detail and you can refer to the transcript or audio file of that presentation for more in depth analysis. Trust fund provisions can be found in the Indemnity Agreement, the underlying construction contracts or in trust fund statutes of applicable jurisdictions.

Section 541(d) provides that property in which the debtor has only legal title becomes property of the estate **but** only to the extent of the debtor's legal title, the equitable interest in the property does not become part of the estate. So, we see from subsection (d) that the Bankruptcy Code has been drafted in a way to protect trust property, by expressly recognizing and preserving the special nature of trust funds and the distinction between legal title and equitable title.

The court will look to state law to determine if a valid trust exists and what rights the Debtor and surety have. The surety will have the burden of proof in establishing the existence of a trust. Most courts hold that trust fund provisions in the general indemnity agreement, construction contract or trust fund statute are valid and rule that the trust property is not property of the estate. Thus, those trust fund provisions can be used by the surety to argue that the debtor cannot assert control over the Bonded Contract Funds pursuant to Section 363 because the funds are subject to a trust.

c. **Equitable Subrogation** - Equitable subrogation arises by operation of law, it is not dependent upon contract, nor upon privity between the parties; it is a creature of equity, and is founded upon principles of natural justice. As one court noted "[t]he rationale of subrogation is bottomed on a sensitivity to the comparative equities involved. Where one is more fundamentally liable for a debt which another is obligated to pay, such person shall not enrich himself by escaping his obligation."

The Supreme Court has noted that "there are few doctrines better established than that a surety who pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be reimbursed." Thus, where the surety performs pursuant to a performance and/or payment bond, it has rights to reimbursement from the remaining contract funds ahead of the Debtor. Because of the surety's subrogation rights, the remaining funds in the bonded contract are not property of the bankruptcy estate.

The court in *In re Alcon Demolition, Inc.*, 204 B.R. 440, 447-48 (Bankr. D.N.J. 1997) recognized this fact and observed,

> "[t]he doctrine of subrogation has the effect of removing the subrogee's traceable property interest from the bankrupt estate . . . At the debtor's default on the

> underlying contract, he is not entitled to the contract funds because performance has not been completed and because materialmen and laborers have not yet been paid. When the surety performs in the place of a debtor and completes the contract, the entitlement to contract funds arises. However, equity demands that the debtor not receive a windfall. Thus, subrogation places the surety in the position to exercise the debtor's rights to identifiable contract funds, effectively removing that property from the estate and rendering it unavailable to general creditors."

2. **Prior Perfected Security Interest** – Okay, so what if the principal was not in default when the bankruptcy was filed and the surety has not paid out any claims, if the surety filed a UCC1 and has a perfected security interest under Article 9 of the UCC, the surety may assert its perfected security interest in the Bonded Contract Funds as a bar to the debtor's 363 Motion. Because of the security interest, the surety will be entitled to "adequate protection" of its interest in the Bonded Contract Funds just like a traditional lender or other secured creditor. George will talk more about the concept of adequate protection in a moment.

What Does the Surety Hope to Accomplish With Respect to the Bonded Contract Funds?

George: Assuming that both the Debtor and the surety have proven that each has an "interest" in the Bonded Contract Funds, it becomes the surety's main goal in obtaining, and the Debtor's burden of proof in providing the surety with adequate protection for the Debtor's use of the Bonded Contract Funds. Specifically, the surety will want the Debtor to use the Bonded Contract Funds to pay the performance and payment bond claims for which the surety may become liable.

What is the adequate protection that a Debtor may provide to a surety? Section 361 of the Bankruptcy Code defines the kinds of adequate protection that the Bankruptcy Court may grant to a creditor with an interest in the cash collateral. The concept of "adequate protection" involves providing the creditor, such as a surety, with something to protect the surety in addition to the cash collateral, the Bonded Contract Funds, to the extent that the Debtor's use of the Bonded Contract Funds "results in a decrease in the value of such entity's interest in such property." When the Debtor spends the Bonded Contract Funds in a way that does not reduce the surety's risk and exposure to loss for the performance of the work and the payment of the Debtor's subcontractors and suppliers on the bonded project, then the surety faces a "decrease in the value of" the surety's interest in the Bonded Contract Funds – they are not being used to reduce the surety's risk and exposure to loss and liability under the bonds.

The specific kinds of adequate protection described in Section 361 may be more suitable to banks with perfected security interests in the Debtor's receivables.[2]

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[2] Normally, the Bankruptcy Court is faced with the situation where a Debtor wants to use its receivables to pay its bills, which is "cash collateral'" in which a bank has a perfected UCC security interest. The bank would seek to obtain Section 361 adequate protection for the Debtor's use of the receivables, which may include: (a) the

However, Section 361(3) of the Bankruptcy Code authorizes the Bankruptcy Court to provide adequate protection to creditors such as a surety by "granting such other relief" that will result in the surety obtaining "the indubitable equivalent of such entity's interest in such property." In the surety's opinion, the only "indubitable equivalent" to the Bonded Contract Funds ARE the Bonded Contract Funds themselves, and for their use as contemplated by the surety and the principal when the performance and payment bonds were originally executed and delivered to the obligees. As a result, the Bankruptcy Courts, in various cases, have provided the surety with real and beneficial adequate protection for the Debtor's use of the Bonded Contract Funds, which is for the surety to obtain some measure of control over the use of the Bonded Contract Funds, usually along with the Debtor.

Whether by agreement between the surety and the Debtor, or after the surety takes some action to prohibit the Debtor from using the Bonded Contract Funds or conditioning the Debtor's use of the Bonded Contract Funds, the best adequate protection for the surety for the Debtor's use of the Bonded Contract Funds is for the surety to control the Bonded Contract Funds, either on its own or jointly with the Debtor. The chances of this occurring are good and supportable by case law and practical circumstances.

In the transcript of this presentation, we list two relevant cases:

1. *In re Ram Construction Company, Inc.*, 32 B.R. 758 (Bankr. W.D. Pa. 1983). (*See* **Exhibit A**, Section 1)

2. *In re Glover Construction Company, Inc.*, 30 B.R. 873 (Bankr. W.D. Ky. 1983). (*See* **Exhibit A**, Section 2)

The citations to both of these cases may be found in the transcript, and quotations from both of the opinions that emphasize the protections that the Bankruptcy Courts have provided to the surety are contained in Exhibit A of the transcript. The take away from both of these cases, and subsequent cases, is that Bankruptcy Courts have granted the surety with control over the Debtor's use of the Bonded Contract Funds as adequate protection of the surety's interest in the Bonded Contract Funds to ensure that the Bonded Contract Funds pay the obligations for which the surety would otherwise become liable for under its bonds.

The surety may also have a contractual right to adequate protection for the Debtor's use of the Bonded Contract Funds based upon the terms of the Indemnity Agreement or a Joint

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Debtor making cash payments or periodic cash payments to the bank; (b) the Debtor granting a lien to the bank going forward in the cash collateral; and/or (c) the Debtor providing an additional or replacement lien on the Debtor's other property as a substitute for the Debtor's use of the cash collateral. The chances of this kind of adequate protection being offered to a surety or being acceptable to truly protect the surety for the Debtor's use of the Bonded Contract Funds are slim and none.

Control/Escrow/Financing Agreement with the principal executed prior to the principal becoming a Debtor in the bankruptcy case. The terms of those agreements may provide the surety with control over the Bonded Contract Funds – the mechanics and procedures: (a) for the collection of the Bonded Contract Funds; (b) for the Debtor to request the use of the Bonded Contract Funds; and (c) what the Bonded Contract Funds may be used for (the Debtor's performance of the work, including supervision of the Debtor's own labor and the Debtor's subcontractors and suppliers, the payment of the subcontractors and suppliers, and the payment of the Debtor's necessary overhead and general and administrative expenses, etc.).

The terms of those agreements are similar to the kinds of adequate protection terms that the Bankruptcy Courts have granted to the surety in *In re Ram* and *In re Glover*, and the surety should point out to the Bankruptcy Court that such "adequate protection" has already been agreed to by the principal, now the Debtor. Therefore, the surety should argue that the contractual "adequate protection" should be granted as the surety's "adequate protection" for the Debtor's use of the Bonded Contract Funds during the Debtor's bankruptcy case.

What are the Practical Actions that the Surety May Take – or Consider Taking?

A. Monitor the docket and check all notices

Mike: Motions that may affect collateral, contract funds, etc. could be filed at any time in the bankruptcy process, so the surety will need to be vigilant to protect its interests. It is not uncommon in Ch 11 proceedings, for example, for the Debtor in possession to file a bunch of first day motions with the filing of the bankruptcy and those motions typically include motions to use cash collateral under Section 363. It is also not uncommon for the Debtor, trustees and other creditors like secured lenders to be unaware of the surety's interests in the Bonded Contract Funds and deals often get made regarding the use of the Bonded Contract Funds without any consideration of the surety's interests and rights. Thus, the surety must always be sure to review the dockets and notices.

B. Call the Debtor's Counsel and Alert the Debtor's Counsel of the Surety's Rights to the Bonded Contract Funds.

As noted above, Debtors, trustees and secured creditors are often unaware of the surety's rights and interests in the Bonded Contract Funds. They wrongly assume that if no UCC1 has been filed, there is no interest in such funds. Accordingly, one of the practical tips for early on in a bankruptcy is for the surety to contact the Debtor's counsel and determine whether counsel is aware of the surety's rights and interests. If they are not, then an "education" must be provided. During that call or subsequently, it often makes sense to see if a deal can be worked out regarding use of the Bonded Contract Funds to pay subs and suppliers on the bonded project and/or to complete the project. If you can't work out a deal, then you will need to litigate in the bankruptcy court to protect your interests.

C. Motion to Prohibit or Modify the Debtor's Use of Cash Collateral (the Bonded Contract Funds) under Section 363(e) of the Bankruptcy Code.

Pursuant to Section 363 of the Bankruptcy Code the Debtor is not entitled to use cash collateral, such as the Bonded Contract Funds, unless (1) the parties that have an interest in such cash collateral consent to the use of the funds; or (2) the bankruptcy court, after notice and a hearing, authorizes the Debtor's use of the funds. However, sureties should be aware that Debtors often use cash collateral without complying with Section 363 until a creditor objects or takes some action to restrict the use of such funds. Because the Code does not provide any sanctions for a violation of 363, Debtors do not always properly police themselves. Accordingly, in a case where there is significant cash collateral, the surety should consider filing a notice when it enters the case advising that the surety does not consent to the Debtor's use of the Bonded Contract Funds as cash collateral.

The surety may also want to consider filing a motion under Section 363 to prohibit or modify the Debtor's use of the Bonded Contract Funds as cash collateral. As George noted, Section 363(e) of the code provides that at any time, on request of an entity that has an interest in cash collateral the court may prohibit or condition such use as necessary to provide adequate protection of such interest. Of course, the surety will have the burden of proof on the issue of the validity, priority, or extent of the surety's interest in the Bonded Contract Funds.

D. The Surety's Notice to the Obligee.

Another practical tip to consider is providing a notice to the obligee explaining the respective rights of the parties in the Bonded Contract Funds and the obligee's obligations with respect to such funds. The surety must be careful with this kind of communication because of the automatic stay. If the surety simply told the obligee not to pay the Bonded Contract Funds to the Debtor, that would likely be viewed as a violation of the stay. But, the surety may be able to avoid running afoul of the automatic stay if the communication with the obligee is one that simply explains the rights and the law. The notice can detail the rights of the parties are under the bond, the bonded contract and at law, remind the obligee that it has an obligation to protect the surety's interest in the contract funds, and notify the obligee that if it fails to satisfy its obligations the surety may be discharged or the obligee may be forced to pay twice. There should be no explicit direction not to pay, only "friendly" advice as to the rights and possible consequences.

There is no case law directly on point addressing this option, so there is a risk that some court might construe the communication as a violation of the stay. But, there is also risk in not sending the letter, because just as the Debtor, Trustees and Creditors may not be fully cognizant of the surety's rights, obligees may be similarly unaware. The problem is the obligees are generally the party holding the funds and it is much easier to try to convince the obligee up front

to hold the funds then to litigate in the bankruptcy court to get the Debtor to disgorge the funds that were improperly paid or to litigate with the obligee over improper payment issues.

The Effect of the Surety's Financing of the Debtor in its Chapter 11 Bankruptcy Case on the Surety's Rights to the Bonded Contract Funds – Briefly

George: The final issue that we will address is the effect of the surety's financing of the Debtor in its Chapter 11 bankruptcy case on the surety's rights to the Bonded Contract Funds.

Let's face an obvious fact that the surety's financing of its principal, outside of a bankruptcy case, is usually not favored by most if not all sureties. Financing is normally done in unusual circumstances: (a) the principal is honest and competent, and just lacks the cash to perform; (b) there are really no better alternatives, and the estimated costs to complete the performance of the work are better with financing than other options; (c) the surety may preserve valid affirmative claims; and/or (d) the principal and the indemnitors may have other assets to serve as collateral for the surety that the surety may acquire, among other reasons.

Despite such circumstances, why would a surety finance a Debtor in bankruptcy?

The initial issue is what does surety "financing" of the Debtor in its bankruptcy case look like? There are at least two possibilities. First, the surety may provide cash to assist the Debtor in performing the existing bonded contract work and to pay its subcontractors and suppliers on the bonded projects – both of which are payment obligations that the surety may already have under its performance and payment bonds. This financing may help solve the immediate problems of the performance of the existing work.

Second, the surety may provide additional surety credit to the Debtor in the form of surety bonds on new projects. This may result in the surety reducing its ultimate loss through future reimbursements and keeping a customer on an ongoing basis. It also might increase the surety's loss in the long run.

In either case, the surety is providing new consideration and surety credit to the Debtor, and would want consideration in return from the Debtor.

Section 364 of the Bankruptcy Code addresses the Debtor's obtaining of credit, including surety financing. The Debtor requires Bankruptcy Court approval to obtain new surety credit – whether it is the surety's cash or new surety bonding. Since the normal protections in Section 364 rarely apply because the Debtor never has new collateral to provide to the surety, the surety will require for its financing, among other things, control over the Bonded Contract Funds as adequate protection to ensure that they are used to reduce the surety's exposure to loss and liability under its bonds. (*See* **Exhibit B** for some of the other things the surety may want.)

In summary, if the surety provides financing of some kind to a Debtor, one of the surety's first requirements will be to obtain control over the Bonded Contract Funds as adequate

protection for the surety financing. Therefore, financing the Debtor, if it otherwise makes sense for the surety, will result in the surety's obtaining control over the Bonded Contract Funds. If the surety's financing of the Debtor makes **no practical or economic sense**, then Section 364 will not benefit the surety in obtaining control over the Bonded Contract Funds.

EXHIBIT A

In re Ram Construction Company, Inc. **and** ***In re Glover Construction Company, Inc.***

Section 1 – ***In re Ram Construction Company, Inc.***

In *In re RAM Construction Company, Inc.*,[3] the court referred to an earlier preliminary order which provided the surety with adequate protection by limiting the debtor's payments to those expenses required to keep the bonded contracts ongoing. The court stated:

American States was permitted to control RAM's payments of these expenditures to assure that the owners' monies received was dedicated to the ongoing expenses of an owner's contract.

Additionally, the Debtor was ordered to provide an accounting for each contract, so that income and expenses could be reviewed by Equibank and others. The Debtor was not permitted to use these monies to pay for equipment and other expenses not necessary on the ongoing contracts.

Also, salary payments to the Debtor's stockholders-officers and their relatives was limited by this Order and a following Order.

This Order was entered for several reasons. The Court believed that the surety would not be adequately protected if the Debtor was free to pay money received from the owners for Debtor expenses on other contracts, etc. Additionally, if the Court did not fashion such protection, the Court believed the surety would request a lifting of the stay and put another contractor on the job and claim the balances owed by the owner to the Debtor. Under the facts represented, the Court believed the surety would succeed and RAM's Chapter 11 would have a short life.[4]

Section 2 – ***In re Glover Construction Company, Inc.***

In *In re Glover Construction. Co., Inc.*,[5] the court found that progress payments were property of the debtor's estate under section 541 of the Bankruptcy Code, and that the surety had an interest in the contract funds. In citing favorably to the *RAM* decision, the court reiterated:

[T]he same attitude we have expressed in numerous rulings in open court in the Glover case: that the stream of payments cannot be diverted from the jobs to which they relate. We have consistently ruled, on various motions, that payments must be first applied to those claims

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[3] 32 B.R. 758 (Bankr. W.D. Pa. 1983).

[4] *Id.* at 759.

[5] 30 B.R. 873 (Bankr. W.D. Ky. 1983).

on which the surety is or may become liable before the Chapter 11 debtor can be paid the first discretionary dollar.[6]

Subsequently, after discussing the trust nature of the contract funds, the court stated:

To the extent that the surety is actually seeking "adequate control of the debtor ... so that contract proceeds go first to contract claims," American States is seeking a protection which has already been extended by the Court in a series of interim rulings at every stage of this proceeding. Until such time as it is possible to precisely quantify the ultimate liability of surety, it will be the unrelenting demand of this Court that progress payments be disbursed in the following order:

(1) to bona fide claims against the jobs, for the period in question, concerning which American States may become liable, and

(2) subject to the availability of periodic surplusages, to those items of the contractor's job-related operating and overhead expenses which are ordinary and necessary, most stringently viewed.[7]

In summary, a surety that can establish that it has an interest in the Bonded Contract Funds is entitled to adequate protection under sections 361 and 363 of the Bankruptcy Code for the Debtor's use of the Bonded Contract Funds as "cash collateral."[8]

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6 *Id.* at 880.

7 *Id.* at 882.

8 In *In re* Glover Constr. Co., Inc., 35 B.R. 233 (Bankr. W.D. Ky. 1983), the surety (American States) attempted to lift the automatic stay in order to obtain control over the contract funds. The court refused to lift the automatic stay, finding that the surety already had adequate protection by reason of the joint control of the contract funds by the debtor and the surety and the stated priority of payments established by the court in *In re* Glover Constr. Co., Inc., 30 B.R. 873 (Bankr. W.D. Ky. 1983). The court stated:

> Our refusal to immediately lift the stay does no harm to American States beyond that which has already been done, prepetition. Further, our order of March 23, 1983, vests American States with the power of the purse during the remaining life, however short, of this project. A more powerful form of "adequate protection" would be hard to envision than the surety's continuing veto power over all disbursements by the Chapter 11 trustee.

Id. at 236.

EXHIBIT B

Other Things the Surety May Want as Adequate Protection for its Financing of the Debtor

A surety that finances the Debtor in bankruptcy under Section 364 of the Bankruptcy Code may obtain certain additional rights for the protection of the surety to give the surety adequate protection not only under Section 364 of the Bankruptcy Code, but also under Section 363 of the Bankruptcy Code for the Debtor's use of the Bonded Contract Funds as "cash collateral." The additional protections that the surety should obtain under Sections 362, 363 and 365 of the Bankruptcy Code include the Debtor's providing the surety with consensual relief from the automatic stay provisions of Section 362 of the Bankruptcy Code in order for the surety to exercise the following rights:

- Authorizing the surety to exercise its rights against the Bonded Contract Funds, including the deposit of the Bonded Contract Funds to an account in which the surety has an interest and control and the use of those Bonded Contract Funds to pay bills for which the surety would be liable under its bonds;

- Authorizing the surety to negotiate and settle all claims of subcontractors and suppliers against the payment bonds without subsequent Bankruptcy Court approval;

- Prohibiting the Debtor from assuming or rejecting any of the underlying bonded construction contracts without the surety's consent;

- Authorizing the surety to begin negotiations and discussions with obligees and other contractors concerning the potential reletting and/or completion of the bonded contracts;

- Authorizing the surety to terminate any of the bonded contracts between the obligees and the Debtor as the surety deems necessary; and

- Authorizing the surety to exercise any other rights and take any other actions as negotiated by the surety and the Debtor.

In addition, the surety will also want the elimination of any preference claims against the surety resulting from the surety's prior obtaining of collateral within the 90-day preference period or the Debtor asserting preference actions against its subcontractors and suppliers who received payments on the bonded projects within the 90-day preference period that could result in the surety's liability for preferences and/or subsequent bond claims in the future.

This list should not be considered to be an exhaustive list, and other protections may be considered in the appropriate case.