SURETY TODAY:
The Surety's Use of Collateral Demand
June 13, 2016
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THE SURETY'S COLLATERAL DEMAND

I. INTRODUCTION

Hello everyone. Welcome to this edition of the Surety Today Program regarding the Surety's Collateral. My name is Mike Stover. I'm a partner with Wright, Constable & Skeen here in Baltimore, Md. and I am joined today by Cynthia Rodgers-Waire, who is also a partner at Wright Constable. I am going to now turn the program over to Cindy.

II. PURPOSE

Cindy: The obvious reason you would make a demand for collateral is you have a claim or you feel that a loss is imminent and the surety has a right both under common law and under its contractual indemnity agreement to be exonerated and indemnified by its principal and indemnitors. So of course, the obvious reason is that you actually want to get the collateral in hand to be able to reimburse yourself for that loss. While that's great and everyone wants that collateral demand to be satisfied, there are also other strategic reasons why you might want to make a collateral demand even when you know based upon your dealings with this principal, or because you've seen the financials, that the likelihood of them being able to meet your collateral demand with cash or other collateral is fairly remote.

For example, let's say there is either a performance or payment bond claim pending and you conducted your independent investigation of that claim, and you believe that the claim should be settled, but your principal or the indemnitors want you to keep fighting that claim to the bitter end. In a similar vein, even if your principal and indemnitors aren't really giving you feedback on the claim, and you're sort of out there on your own resolving or attempting to resolve that claim, but you just get a sense that at the end of the day after you resolve that claim and there is a demand for indemnity that your principal and indemnitors, or perhaps their attorneys, are going to come back and second guess every decision that you made along the way, whether it was to settle it, or your trial strategy. A way to circumvent or hopefully eliminate some of those problems down the road is to make that demand for collateral: if you want the surety to take this certain strategy, you have to put up the money, you have to finance the pursuit or defense of this claim; kind of like a "put up or shut up" thing and if you want the surety to gamble, then you need to let the surety gamble with your money and not the surety's money. If the principal is not willing to take that bet by using its own money, why should the surety?

There are many cases and we certainly do not have the time in the context of this 30 minute conference to go through the case law, but I would direct you to THE SURETY'S INDEMNITY AGREEMENT 2D ED., as a lot of good cases are cited there. Essentially, they say that unless the principal has made a specific request for the surety to litigate and has also, in conjunction with that, honored the surety's collateral demand, then the surety is free to go settle and the indemnitors are going to be liable for any expenses that the surety has incurred. Now, always with this, you have to understand that you are always going to have an obligation to settle or otherwise resolve in good faith, but this gives you a "leg up" where you have made a collateral demand and it has not yet been responded to.

Another similar situation is when the principal has affirmative claims that it thinks are wonderful and that they're going to make the surety whole and you want to be able to resolve those claims, with an obligee particularly, and the principal is gunning for you to hold out. Again, the unfulfilled collateral demand gives you that leverage to settle that claim and then not have it on the flip side where they are fighting on the indemnity that you should not have settled for the amount you did.

Another reason, too, if they want you to tender the defense to them and you are not quite comfortable with either who they want to use or you just don't have a good feeling about tendering in that case, you don't want to have an issue on the back end where they can claim that they shouldn't have to be paying for the attorneys' fees that the surety hired. Again, that collateral demand that gets unfulfilled gives you higher standing to sort of contest that defense.

Another thing is an unfulfilled collateral demand constitutes a breach under the indemnity agreement and can trigger all kinds of other rights like the attorney-in-fact provision where you might be able to take other steps and assert rights under the indemnity agreement to minimize your losses and acquire maybe access and other things you can do to try to control the loss. I'm going to turn this back over to Mike.

III. MECHANICS OF MAKING THE COLLATERAL DEMAND

Mike: Okay, so I want to spend a few minutes to talk about the mechanics. You've made a decision to demand collateral and there are a couple of issues to talk about on the mechanic's side of the fence.

A. Follow the Requirements of the GAI

This is basic and everybody certainly knows to do this, but I would be remiss not to say it. You have to follow the requirements of your GAI in making the demand for collateral. You would be surprised at how many times this is not done. You really have to look at the provision and make sure that you are following exactly what is required. If the provision says that the collateral can be demanded if you set a reserve, you have to set

a reserve first. If you don't, you're going to be running into the issue of whether you met the condition precedent, etc. So, a lot of the provisions out there vary from company to company, so you just have to read to see what you've got. If there is written notice required for the demand, you have got to send it to whomever the GAI says it has to go to and you've got to send it in a manner that is required. If it says certified mail, send it certified mail. If you intend to make the demand upon the principal and the individual indemnitors, then you need to make sure that the notice or the demand is going to those individuals, as well, especially the individuals who may not be involved with the business. You want to make sure they are getting their notice and their demand for the collateral because later if they don't provide it and you want to sue them, you want to make sure that you have complied with the GAI. Same thing with any timeframe; if you have to give them a period of time to comply with the demand, allow that timeframe to pass before the next step.

Basically following the GAI you just want to not give the indemnitors' counsel or the court any reasons or grounds to claim that the surety was acting improperly or that the surety did not follow its own agreement. So, that's the first sort of mechanic issue.

B. Use a Collateral Agreement

The next one would be the recommendation to use a collateral agreement. The GAI, when it has a provision for collateral demand, typically does not have very much detail of any kind or any kind of broad description of how you're going to do it, what's going to be done. It typically just gives you the right and creates the obligation. There are a lot of questions. We have had numerous occasions, you remember the one we had in bankruptcy, where they wanted the collateral and we ended up filing an opposition to the motion to turn over the collateral and it was a big, drawn out battle. There was no collateral agreement to really set forth the rights of the parties. So in the absence of an agreement there can be fertile grounds for disputes.

If you have a collateral agreement you can talk about in that document, identify the collateral to be used, what the purpose of the collateral is, for what reason you're holding it, for what purpose you're going to use it if the need arises. Certainly, you're going to use it to reimburse yourself if you pay a loss, but you may also want to use it to pay your attorneys' fees, or you may want to pay unpaid bond premiums and things like that. So, you have to set that out in your agreement and also you would want to provide how the collateral will be held, how it will be used, how it would be sold, if there is going to be insurance on the collateral, who is going to pay the premiums, are there going to be inspection rights, what happens to any interest or income that is generated from the collateral; all that would be something you would put into the collateral agreement. Also, when is the collateral going to be released? There have been numerous disputes where the principal and indemnitors are claiming that since you're holding all this money and the current disputes are resolved, the money should be released, but the surety still has

exposure and potential liability out there, so putting that clearly in the agreement goes a long way toward heading off future disputes.

C. Properly Perfect Your Interest in the Collateral

So the next thing would be from a mechanic's side, you've made the collateral demand, you have the collateral now and you have to make sure you properly perfect your interest in the collateral so that it is protected and preserved while you're holding it, particularly if you've gained the collateral up front before the bonds are issued. You may be holding that for years, and you have to make sure that you have done what is necessary to perfect your security interest in that collateral and depending on the type of collateral, and Cindy will talk about that in a few minutes, sometimes you have to do more than just file a UCC1 financing statement.

You have to look at the type of collateral that you have and figure out what needs to be done. For instance, if cash is your collateral, you perfect your interest in that by possession. Maybe your collateral is bank accounts. You can perfect your interest in that by control of the bank accounts. If you have certificates of deposit as your collateral, that can be complicated because of the type of certificate of deposit. Under the UCC, depending on whether it is certificated or not certificated, it could be treated like a regular deposit account or could be treated like an instrument. It really depends on the nature of the CD. If you've got vehicles or movable equipment, you have to secure your interest by having title to these vehicles. For real property, of course you have to perfect your interest through the land records. So, one aspect that the collateral demand is making sure you follow the mechanics.

IV. QUIA TIMET/EXONERATION

What if the issue is you don't have a collateral demand provision in your GAI? I just read one the other day that did not have one, and of course, the commercial side of the fence tends to use the short-form indemnity agreement, which barely has anything in it. Where are you if you don't have that collateral demand provision?

A. Commercial Leverage

Initially you have the commercial leverage. If they want the bond they are going to have to give the collateral. You can certainly demand that up front or maybe even midstream if they want additional bonds or other projects, you can request collateral then. I think it's common on the commercial side to get that collateral up front or to increase as the time goes on. I think on the commercial side there is more leverage if the principal wants to continue the bonds, then they have to give the collateral. If they don't give the collateral, then the surety just cancels. You can't do that on the contract side of the house because once you issue that bond for a project, you're stuck there, but that certainly is

something where the economic leverage is out there as a tool, even if you don't have a provision in the GAI for collateral demand.

B. Common Law Rights

The other thing that can be used is the ancient common-law rights of *quia timet* and exoneration. These are rights that have been around for a long time and have long been recognized as rights held regardless of what your GAI says or doesn't say, these rights are out there and could be used under the right circumstances.

(i) Quia Timet

Quia timet is basically Latin and translates into "because one fears or apprehends." It's part of a type of writ that was known in the common law as a writ of prevention. So basically, when the surety reasonably believes it may suffer a loss in the future because the principal is likely to default, then the surety can assert the right of *quia timet* to be placed in funds or collateral before the surety actually incurs a loss. It is essentially a common-law version of a collateral demand provision in your agreement. Typically the elements are you have to show that there is an obligation of the of the principal that is or will become due or is likely to become due, that the principal will be liable for that debt, that but for the equitable relief the surety will be prejudiced and that there is no adequate remedy at law.

(ii) Exoneration

Exoneration is very similar to *quia timet* and really the primary difference between the two is one of timing. The exoneration right can be raised after the debt of the principal has matured and becomes due and before the surety has paid. The surety can demand the common-law right of exoneration and have the principal pay the debt out of its own funds before the surety has to, and that was something that was recognized at common law.

(iii) Rationale

Again the rationale here is that the principal is primarily obligated for the debt and that the surety should be allowed to force the principal to pay its debt out of its own funds before the surety is required to do so. For a further discussion of these rights, take a look at the ABA/FSLC book THE SURETY'S INDEMNITY AGREEMENT - LAW AND PRACTICE 2D., Chapter 6. Footnote 6 to the Chapter also calls out a number of other resources - books and chapters. Also, the RESTATEMENT OF SURETYSHIP AND GUARANTY, section 21 discusses the right of *quia timet* and exoneration and some of the comments there explain those rights in greater detail as well. Back to Cindy.

V. TYPES OF COLLATERAL

Cindy: As Mike mentioned, there are different types of collateral, and how you get it and what you get may vary depending upon the commercial side versus the contract surety side. Commercial bonds are issued, and generally they are continuous in nature. They are subject, most of the time, to annual renewal and there is an option in the bond form typically or in the statute on which they are based, to cancel them. Often times on the commercial side, the collateral is requested up front before any bonds are issued at all but there are also many cases where either an increase is made in the collateral demand or an initial collateral demand is made when the surety's underwriting side is evaluating the principal's financial condition and sees that things are starting to turn negative and the surety wants more protection if it's going to continue to keep the bonds in place. So, there is certainly some leverage on the commercial side to sort of get the collateral up front or get the collateral that you need that may not exist on the contract surety side.

As you know, once you issue a contract surety bond, you are pretty much stuck with it. There is no way to cancel those, but on the positive side on the contract surety side there are contract funds where you never have that on the commercial side. So, that is one source of collateral that is a very important part, but we don't necessarily think of it in terms of calling it "collateral" but certainly the contract funds are the surety's collateral. So, unfortunately, on the contract surety's side, we tend to only make collateral demands after there are already claims, probably when the principal least likely has the means to honor those demands.

Also, there are all types of collateral out there that can be requested. As Mike mentioned, there is cash, deposit accounts, letters of credit, liens on real property, liens on equipment, vehicles, personal property such a jewelry, pretty much anything that has value. There is a way to make any of that your collateral, but every single different type of collateral is different, so you have to go back, often to the UCC and various other statutes that define how you secure and assert your priority stake in that type of collateral. So what do you want to do?

First of all, the most obvious thing is you can only get collateral that is available, so if your principal doesn't have cash assets to put up as collateral, then that's not really going to be an option. What best retains its value is something important to consider. What is the one that is easiest in terms of securing your priority interest? If you have to go through a lot of trouble to store something, to insure it, to keep possession of it, to file documents to secure your interest in it, that has to be factored in. Lastly, which one of those is the easiest to liquidate? So you have all of those factors that go into what collateral you are willing to take and maintain.

Obviously, real estate has always been a big thing and has historically been a big thing to choose, but we found ever since 2008 that real estate may not be that great piece of collateral that we once thought it was because it's not always appreciating in value. We have seen some amazing pieces of property that were the surety's collateral, but we

were second or third lien holder and all that it really amounted to at that point was a very pretty photo on the screen that really didn't help us much. I think there are some people calling in who probably know exactly what pieces of property I'm talking about in a few cases.

We've got things like very expensive boats, very high-end antique vehicles; all of those things look great on paper but we all know they decline in value very rapidly and their values can be very subjective, based upon the circumstances. For example, art work, same thing, you're talking about something that the value is in the eye of the beholder and is very driven by the current state of the market.

Letters of credit are very valuable to have as don't have all of the upfront expenses. You have to be very careful with them in the sense that you have to read them because depending on how they are worded, they may be written with an expiration date. You are supposed to get notice if they are ready to expire, but that certainly is not something you can rely upon. If you have a letter of credit and it expires before it gets called upon, then you are left without any collateral at all.

One of the other things you have to think about is getting a security interest in equipment. I think a lot of us have been in that situation where you go to into a principal's shop and there are fixtures and equipment in which you have perfected your UCC security interest and you're feeling very good about it because you've got all of these assets and collateral. You may even have the first position in it. The principal's condition continues to deteriorate, and you go back months or years later and all of a sudden, that shop that was full of all of the equipment and inventory is bare and you find out that either the principal or someone else sold all of those assets, notwithstanding your security interest, and it's not always the easiest thing to go back and chase after the purchaser because you end up having to litigate and that can be very challenging to do. As Mike mentioned before, also you can have something where you have to hold it to perfect your security interest, and then you are talking about storage costs.

Then, lastly there is the fun one where your collateral has to be fed, that's always a good one, or crops or other things that have a very short lifespan, so those are the most challenging types of collateral that we see and hopefully, we don't have to get down to that level. I'm going to turn this back over to Mike.

VI. ENFORCEMENT

Mike: Let's talk about enforcement. Basically, enforcement of the collateral demand is where you've made the demand, they haven't provided it, so what do you do? Typically counsel will use either injunctive relief or specific performance to try to enforce the collateral demand. We found, as I mentioned earlier, about 16 cases over the course of the last six or seven months that dealt with the surety's attempt to enforce its collateral demand provision and of those cases, nine had the relief granted and in six of them the

relief was denied, so the surety made demand, and the demand was either ignored or refused and the surety went to court and filed a suit in order to get injunctive relief or specific performance and the court denied that.

There are a number of reasons primarily in those cases where the court finds that there was no sufficient showing of irreparable harm and basically under the irreparable harm element of injunctive relief, you have to show that if the relief you are requesting is not granted, you will be harmed in a way that cannot be compensated in money damages. So, the courts will look at this and say that you are demanding money and they are not paying you the money, so you want the money and that's economic and you are not showing irreparable harm . So, that's something that your outside counsel will deal with. There are a couple of takeaways from these cases that I wanted to touch on that the claims folks should be made aware of.

A. Delay

This issue was is in two of the cases, the issue was cited by the court that the surety delayed in seeking to enforce its rights under the collateral demand provision, and one court cited the old equity maxim that equity aids the vigilant and not the party who slumbers on its rights. So, you don't want to be slumbering on your rights. In one of the cases it was only six months; the other was about a year and a half. Basically, the courts said if you're going to wait around and delay in enforcing your rights, that says to the court that you're not really looking at irreparable harm, so the courts will use delay against you if they can.

B. GAI Language Not Always Enough

You have to be careful with the GAI language sometimes, because the provisions will say we agree that if the surety has to move to enforce it, the surety is entitled to injunctive relief or we agree there is irreparable harm, but one of the court's recent decision regarding that language said that such language doesn't bind the court. The court said; we look at this and we determine if the right exists and if it does, we will enforce it but it if doesn't we won't and what you put in your contract isn't going to make any difference. That's what one of the cases held.

C. Sometimes in Certain Jurisdictions It's Just Difficult to Enforce

The final point is sometimes it's just difficult, depending on the jurisdiction you are in because there are a lot of those cases out there that say the surety is entitled to enforce these provisions and are entitled to specifically enforce injunctive relief, but there are some courts that are really stingy with it. One court in one of these cases has a motion for enforcement for injunctive relief that was unopposed. The indemnitor did not oppose the motion but the court still denied it. It just shows the mindset of the court that

basically you have to go a long way to establish the right of injunctive relief in some jurisdictions.

VII. COLLATERAL IN BANKRUPTCY

Cindy: When the principal files for bankruptcy, you have a whole new set of rules. So the Bankruptcy Code very broadly defines what is property of the bankruptcy estate, and most times what you are holding as collateral is going to be considered as property of the bankruptcy estate, so you should go under that assumption until you find out otherwise.

That matters because the Bankruptcy Code puts an automatic stay on the commencement of any action or continuing of any action against the debtor or the debtor's property. So, the surety must be very careful to avoid taking steps to get the collateral that are going to cause you to be found in violation of the automatic stay because you could actually have sanctions imposed against you. Now, if you didn't know about the bankruptcy because the surety wasn't told, which unfortunately happens more often than we'd like, you're not going to necessarily be found to be in willful violation of the stay, but that doesn't mean that you can continue to go forward with trying to secure that collateral. That also doesn't mean that your hands are completely tied. There is a way to go into the court to seek relief from the automatic stay. If you have a security interest in certain property, you may be able to get relief from the automatic stay and be able to pursue taking that collateral and disposing of it to reimburse the surety. To successfully pursue such an action, there must be value in that security interest as opposed to being third lien creditor on something where there is no equity so all of that is going to have to factor into whether it makes sense for you to try to seek relief from the automatic stay.

Now, typically, say you have a security interest in a piece of equipment. The debtor is going be allowed to continue using that equipment in the ordinary course of its business as a construction contractor. They are just not going to be able to dispose of it without bankruptcy court approval. So, using it during the course of the bankruptcy is still okay.

Cash collateral is going to be a different thing; under the Bankruptcy Code there is more of a restriction on the debtor's use. Generally, if the surety has a secured interest in the cash collateral, the surety will have to either give its consent or the debtor is going to have to get court order subject to the surety's objection as to how it can use that cash collateral. A perfect example of that is bonded contract funds, and typically what you will see is that the surety and principal come to an agreement as to how those funds can be used. The surety is not going to have an objection if those funds are to be used to pay bonded subcontractors' and suppliers' claims because that is going to go towards mitigating the surety's loss. However, the surety may object if the debtor is trying to use those funds for other purposes that do not minimize the surety's exposure.

Letters of credit are actually a very good thing to have when there is a bankruptcy because they are generally not considered property of the debtor's estate. They are issued by a lender so the surety is typically free to go out and call upon those letters of credit to get that collateral without having to go through the automatic stay issues or seeking the court's permission. So that's probably the best one to have in that circumstance.

Finally, there is the issue of holding the collateral when the surety doesn't have actual claims at that time but has risks. There is a long discussion of that. We are out of time here but The Law of Commercial Surety and Miscellaneous Bonds, the chapter that Mike wrote with George Bachrach of our office, describes some of the ways you may be able to figure out how to hold onto that collateral because your risk is still out there. So, we have to wrap it up now and Mike is going to hit some buttons so that we can open it up for questions.

Mike: Before we go into the questions and answers, I want to remind everyone that the next edition of Surety Today will be Monday, July 11 at 12:30 EST, using the same call in number, code and pin. The topic will be "The surety and the Federal Government." Upcoming events will be the Surety Claims Institute, June 24 in Newport RI and I think most things are kind of down for the summer. The Northeast Fidelity Claims Conference will be September 21-24 so again, thank you everyone for calling in.

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