

Bankruptcy And The Completing Surety

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Introduction

The life of the completing surety is seldom easy. Deciding what to do when called upon to perform can be, even in the best of times, a challenge. Clarity often proves elusive:

The Surety's decision on what to do must be based upon a solid foundation of expert, thorough and incisive fact gathering and assimilation. Within a relatively short time, the company person in charge of that effort must carefully and accurately marshal and analyze a great volume of critical information. It is a most difficult and demanding task.¹

Nevertheless, as difficult as the surety's decision may be, once made, the transition from the investigation and evaluation stage to actual performance by the surety can, in the normal course, proceed relatively smoothly:

If the surety elects to do so, takeover can occur quite quickly following a default. If the principal defaults and the obligee makes demand for performance upon the surety, the surety may perform by taking over the work. There need not be an agreement or negotiation between the surety and the obligee, although a general consensus over the completion approach is desirable. Takeover need not require a lengthy rebid process. If time is of the essence and momentum on the project is important to the surety, it can take over the contract and initiate work via the subcontractors, establish a fixed-fee or time and materials basis with the new contractor, use its own forces, or take other steps to expedite the work.²

That is, as long as the contractor bonded by the surety stays out of bankruptcy. Once the principal passes over to the "dark side," the surety enters an alternative universe where the simple can become complex and the complex nearly unmanageable for those unable or unwilling to aggressively manage their environment.³ As with most zero-sum environments, bankruptcy

¹ Wayne H. Webster, "The Surety's Decision On What To Do," 17 Forum 1168 (1981-1982). *See also* Patricia H. Thompson, "Completion Options Available to a Performance Bond Surety Other Than Financing Its Principal," 17 Forum 1215 (1981-1982) ("It is within [a] war zone atmosphere that the surety must decide on a course of action when notified that its contractor is in default.")

² William Schwartzkopf, "Practical Guide to Construction Contract Surety Claims," §13.02 (2009).

³ Many of the basic provisions of bankruptcy law are counter-intuitive:

rewards timely and decisive decision-making while punishing passivity. What follows is an examination of a number of obstacles the performing surety is likely to encounter upon its principal's filing a Chapter 11 case. Each situation is unique, limiting the usefulness of generalizations and qualifying the "lessons learned" one can draw from bankruptcy law and bankruptcy lore. We will look at the issues involved when the principal is cooperative and financing is a possibility. The situation of the uncooperative principal seeking to assume an unprofitable contract or make no decision with respect to bonded work will also be reviewed.

I. Pre-Petition Activities That May Influence The Surety's Rights And Obligations Post-Petition

While a surety may be surprised by its principal's bankruptcy, in the usual case telltale signs of pending disaster are apparent. Mounting payment bond claims, delayed performance, growing disputes with vendors and others, and slow response to requests for financial information can be signs of serious financial deterioration. A dialogue may ensue in which the principal acknowledges difficult economic times and requests financial assistance. What's the surety to do if it believes the principal is a candidate for bankruptcy which might leave it exposed to substantial loss?

i. Pre-Petition Financing of the Principal by the Surety

For many surety professionals, the financing option should be coupled with the observation that "no good deed goes unpunished." Without a doubt, pre-petition financing of a troubled principal gives rise to a number of complexities. From the surety's perspective, one of the worst outcomes is having to pay twice without any reduction in bond penalty. Pre-petition financing presents this possibility if prudent safeguards are not followed. The primary concern is with the Bankruptcy Code's preference provisions. These provisions permit the trustee to unwind otherwise lawful payments. Transfers by which an insolvent debtor favors certain creditors over others (*i.e.*, preferences) were generally not assailable under the common law by the excluded creditors.⁴ In bankruptcy, however, preferences are vulnerable to the avoiding

A client unsophisticated with bankruptcy law needs to be educated. The most basic provisions of bankruptcy law are counter-intuitive. Preference law avoids the valid payment of a lawful debt. While the law emphasizes the sanctity of contracts, bankruptcy law permits executory contracts and unexpired leases to be rejected with the claim arising from the rejection, absent security, only being a general unsecured claim. Section 365(b)(2) overrules *ipso facto* bankruptcy clauses. A senior lien on property is viewed as the best form of security but Code §364(d), under prescribed conditions, permits a senior or equal lien to be imposed upon the existing lien. The bankruptcy power is foremost in reorganization cases. A supermajority of a class of claims or interests can bind the dissenting members of that class. The ultimate power is the cramdown power, permitting the plan to be imposed upon a rejecting class, e.g., a matured mortgage being converted into an installment obligation.

Gerald Munitz, "The Bankruptcy Power and the Structure of the Bankruptcy Code," reprinted in *Understanding the Basics of Business Bankruptcy & Reorganization*, 2008, Practising Law Institute at 47 (2008).

⁴ See *In re Thomas*, 7 B.R., 389, 392 (Bankr. W.D. Va. 1980) ("At common law, this "favoritism" was legitimate so long as the object of the transfer was to pay or secure payment of an antecedent debt.").

powers of the bankruptcy trustee.⁵ Most of the work is performed by §547 of the Bankruptcy Code.⁶

The preference provisions of the Bankruptcy Code usually affect the surety on its payment bond obligations. A trustee's avoidance of a principal's payments to subcontractors and suppliers can increase a surety's bond exposure.⁷ The trustee's avoidance powers, however, also come into play where the surety, in the course of providing financing to the principal, takes collateral as security. If the principal files bankruptcy within ninety days of the surety obtaining the collateral, the trustee or debtor-in-possession may seek to set aside the transfer of collateral to the surety as a preference.⁸ As the theory goes, the surety, by virtue of being both a creditor and co-debtor of the principal, may not improve its position against that of other creditors during the preference period by securing collateral in exchange for taking on an obligation that it already has under its bond.⁹

⁵ See Weisberg, "Commercial Morality, the Merchant Character, and the History of the Voidable Preference," 39 STAN. L. REV. 3 1986; Countryman, "The Concept of a Voidable Preference in Bankruptcy," 38 VAND. L. REV. 713 (1985).

⁶ 11 U.S.C. §547. See also, *Kenan v. Ft. Worth Pipe Co. (In re George Rodman, Inc.)*, 792 F.2d 125, 127 (10th Cir. 1986) ("In general, a 'preference' exists when a debtor makes payment or other transfer to a certain creditor or creditors, and not to others. Such favoritism is prohibited by 11 U.S.C. § 547(b) when a debtor is in bankruptcy.") (citation omitted).

⁷ A particularly troubling trend for sureties is the concept of "indirect preferences." In these situations, the trustee seeks the payment back from the surety, notwithstanding the fact that the surety never actually received the money but only the benefit in the reduction of its payment bond obligations by virtue of the subcontractor or supplier receiving payment. See, *Newbery Corp. v. Firemen's Fund Ins. Co.*, 106 B.R. 186-87 (D. Ariz. 1989) ("[This] theory is based on a bankruptcy maxim that the estate may proceed directly against a surety, instead of circuitously recouping the preference from the creditor, forcing the creditor to proceed against the surety, and then waiting for the surety to assert a claim against the estate for reimbursement."). See also, Berens, "Bankruptcy: Can a Surety be Held Liable for the Pre-Petition Payments Made by Its Principal?", Norton's Annual Survey of Bankruptcy Law, 2009 (1995-96 ed.).

⁸ See T. Scott Leo, "The Financing Surety and the Chapter 11 Principal," 26 Tort & Ins. L. J. 45 (1990) ("The pre-petition financing surety should anticipate any collateral taken in exchange for financing will be subject to §547 as a preferential transfer.").

Some collateral is better than others, from a bankruptcy preference perspective. Letters of credit have been held out to be property of the debtor's estate. See *In re K-Mart Corp.*, 297 B.R. 525 (N.D. Ill. 2003) (letters of credit are not property of debtor's estate subject to automatic stay; beneficiary not prevented from drawing on letter of credit when account party is in bankruptcy); *In re A.J. Lane & Co.*, 115 B.R. 738 (Bankr. D. Mass. 1990) (payment by a third party on letter of credit not stayed because it did not involve a transfer of debtor's assets). But see, *In re Sunset Sails*, 220 B.R. 1005 (10th Cir. BAP (Okla. 1998)), *motion den.*, 222 B.R. 914 (10th Cir. BAP 1998), *aff'd* 196 F.3d 568 (10th Cir. 1999) (letters of credit preferential transfers as the letters were issued to satisfy the principal's antecedent debt, and therefore sureties were ordered to disgorge proceeds).

⁹ There may be defenses to the preference claim including the acceptance of collateral was a "contemporaneous exchange for new value given to the debtor" or the transfer of new value as a "subsequent advance." See *In re E.R. Fegert, Inc.*, 88 B.R. 258 (9th Cir. BAP (Wash.) 1988), *aff'd* 887 F.2d 955 (9th Cir. 1989); *Askenaizer v. Seacoast Redi-Mix Concrete, LLC (In re Charwill Constr., Inc.)*, 207 WL 4570330 (Bankr. D. N.H. 2007); *In re Spada*, 903 F.2d 971 (3rd Cir. 1990); *Fisher Constr. Co. v. Fireman's Fund Ins. Co.*, 420 F.2d 271 (10th Cir. 1969); *In re IRFM, Inc.*, 52 F.3d 228 (9th Cir. 1995).

The Code's preference provisions place a premium on carefully structuring pre-petition financing.¹⁰ Proper control of the funds through trust account and earmarking provisions can be critical to successful financing.¹¹ But, if properly structured, pre-petition financing can be useful to the surety by allowing it to keep progress moving on a critical bonded project, thereby lessening its performance bond exposure in the event of a subsequent bankruptcy filing.

ii. Pre-Petition Termination of Bonded Contracts

Contracts that are not fully completed or terminated prior to a bankruptcy filing become property of the debtor's estate. The most immediate consequence of this designation is that the bonded contract becomes subject to the automatic stay provisions of the Bankruptcy Code. Section 362(a) of the Code provides that the filing of a petition operates as a stay of, among other things, any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.¹² Because the debtor's contracts potentially have value they become property of the estate, subject to the debtor's decision to either assume or reject. Therefore, once filing occurs, the other party to the debtor's contract is constrained from terminating the relationship.

This situation can cause great heartache for both the surety and bond obligee. The obligee is prohibited from terminating the bonded construction contract and calling upon the surety to take over and complete after the contractor files a petition in bankruptcy. If the obligee is a contractor and the debtor one of its subcontractors, the project can suffer significant disruption as the work of the debtor grinds to a halt with no clear path for moving forward with

¹⁰ Bankruptcy, and in particular the preference provisions, is not the only risk a surety runs by financing its principal. The failure to tightly control funds can result in their being squandered on matters unrelated to completing the work of bonded projects. Moreover, the surety's funding can be subject to other creditors' attacks even outside of the bankruptcy context. In *Mascon Equip. & Supply Co. v. Ohio Farmers Ins. Co.*, 2006 WL 2947364 (Ohio Ct. App., Sept. 29, 2006), a surety deposited funds for its principal's use to pay payroll on a bonded job. The account was in the principal's name and the principal had the authority to make withdrawals but with an oral understanding with the surety that the funds were to be used only for the bonded project's payroll. A judgment creditor of the principal garnished the bank account. The trial court permitted the judgment creditor to garnish the funds. On appeal, the surety prevailed as the court determined that the principal did not have authority to expend the funds without the surety's approval. See also *City of Madison v. Bailey-Laffey Constr.*, 495 N.W.2d 95 (S.D. 1993) (joint control account subject to attachment by creditors of principal). Moreover, trust accounts established at the principal's bank may be seized by the bank as an offset for a liability of the principal. *Barnett Bank of Atlanta v. Thurman*, 446 S.E.2d 529 (Ga. Ct. App. 1994); *Gerrity Co. v. Bonaquisti Constr. Corp.*, 549 N.Y.S.2d 532 (App. Div. 1989), *appeal den.*, 553 N.E.2d 1343 (N.Y. 1990); *Aetna Cas. & Sur. Co. v. Bank of Palm Beach & Trust Co.*, 373 So.2d 687 (Fla. Ct. App. 1979), *cert. den.*, 383 So.2d 1189 (Fla. 1980).

¹¹ See William Schwartzkopf, "Practical Guide to Construction Contract Surety Claims," § 16.05 (2009); T. Scott Leo, "The Financing Surety and the Chapter 11 Principal," 26 Tort & Ins. J. L. 45 (1990).

¹² 11 U.S.C. §362(a). The automatic stay of actions and lien enforcement provided for by §362(a) is designed to benefit both the debtor and its creditors. The debtor is given a "breathing spell" in which to attempt to reorganize and creditors are placed on a more or less "even playing field," as it ends competition among them and provides for an orderly procedure to maximize the value of the estate and achieve equality of distribution among creditors of the same class. See *In re Siciliano*, 13 F.3d 748, 750 (3rd Cir. 1994) ("[t]he purpose of the automatic stay is to afford the debtor a "breathing spell" by halting the collection process. It enables the debtor to attempt a repayment or reorganization plan with the aim toward satisfying existing debt."); *Maritime Elec. Co. v. United Jersey Bank*, 959 F.2d 1194, 1204 (3rd Cir. 1991) ("Automatic stay allows debtor breathing spell from creditors and stops collection efforts.").

the work. The surety's dilemma is no less problematic. The bonded project is delayed and the surety's exposure for liquidated damages or other consequential loss mounts.

These unfortunate circumstances can be avoided if the contract is fully terminated prior to the bankruptcy filing. A fully terminated contract has no value to the debtor and, accordingly, does not become property of the estate. Nor does the Bankruptcy Code revive terminated agreements:

[C]ontracts that are validly terminated before filing of the bankruptcy petition are not executory contracts. It is well settled that the filing of a petition in bankruptcy cannot resurrect a contract which terminated prior to the filing. Terminated contracts are not treated as executory contracts by the courts because there is nothing left for the debtor to assume. In such cases, the trustee or debtor-in-possession has no right to assume or reject the contract.¹³

The lesson here, of course, is that an obligee, who legitimately believes its contractor may file bankruptcy and is currently in default of the contract, should seriously contemplate terminating the contract. The problem often arises with respect to the contractor's right to cure defaults. Most construction contracts contain termination provisions which permit a "terminated" contractor to cure its defaults before the termination becomes final.¹⁴ A terminated contract is still "executory" if the bankruptcy petition is filed before the cure period expires.¹⁵ Therefore, terminating a construction cost will generally not shield a party from the automatic stay provision of the Bankruptcy Code, where the terminated party files bankruptcy within the cure period.¹⁶

One way a surety or obligee might address the "cure" issue is to negotiate with the contractor to obtain a voluntary default letter and waiver of the cure period. If there is some

¹³ Deborah S. Griffin, "Post Termination Bankruptcy Considerations for the Defaulted Contractor," 17 *Constr. Law* 24 (1997) (inner quotations omitted). *See also*, *In re Romberger*, 150 B.R. 125 (Bankr. M.D. Pa. 1992); *In re Kong*, 162 B.R. 86 (Bankr. E.D.N.Y. 1993); *In re Huffman*, 171 B.R. 649 (W.D. Mo. 1994).

¹⁴ *See* BRUNER & O'CONNOR ON CONSTRUCTION LAW, §18:15 (2002 & Supp. 2008) ("Standard form construction costs, with the exception of the Federal contract form, expressly provide for the giving of a cure notice by the non-breaching party as a condition of termination.").

¹⁵ *See Moody v. Amoco Oil*, 734 F.2d 1200 (7th Cir. 1984) (contract assumable where debtor filed bankruptcy with one day remaining in cure period).

¹⁶ *See* Deborah S. Griffin, "Post Termination Bankruptcy Considerations for the Defaulted Contractor," 17 *Constr. Law* 24, 25 (1997) ("Under the majority rule, if a construction contract affords the defaulted contractor a cure period, and the contractor files its petition within the cure period, the filing has the effect of preserving the contractor's opportunity to assume or reject the contract as executory. The contractor also has until the time of plan confirmation to determine whether to assume or reject and to cure any outstanding defaults, subject to the right of the other party to the contract to seek an earlier deadline for assumption or rejection.").

The same result occurs where, under state law, the termination is determined to be invalid for one reason or another. *See* Deborah S. Griffin, "Post Termination Bankruptcy Considerations for the Defaulted Contractor," 17 *Constr. Law* 24, 25 (1997) ("If, under state law, a termination by an owner was improper, unjustified, or otherwise void or voidable, that law would be recognized in bankruptcy court and the defaulted contractor would have an opportunity to litigate the issues of state law that would nullify the termination. If the termination were nullified, a consequence of that ruling would be that the contract would be executory and (provided the ordinary requirements for assumption were met) would be assumable under the Bankruptcy Code.").

doubt as to whether the waiver is effective, the parties could simply modify their agreement to eliminate any cure period.¹⁷ In the event the principal is unwilling to negotiate, the surety and obligee might explore the possibility of terminating the contract for convenience with the surety agreeing to be responsible for completing the work. This route could have implications for the surety's reimbursement and indemnification rights, so it would have to be carefully evaluated in light of the specific circumstances presented. Similarly, the owner's unilateral act of issuing a deductive change order might be explored as a way to carve out work from the grasp of the automatic stay. None of these avenues are foolproof, but may be better than waiting around for the "all-too-often" inevitable to happen.

iii. Principal's Waiver of the Automatic Stay

If the surety engages in workout negotiations with the principal that contemplate, among other things, financing, it may want to consider having the principal agree to waive the protections of the Bankruptcy Code's automatic stay. These waivers have been upheld. For example, in *In re Club Tower, L.P.*,¹⁸ a contractor obtained funding for the acquisition and renovation of an apartment building. It defaulted on its loan. The contractor and lender entered into a workout agreement where the contractor agreed that the lender would be entitled to immediate relief from the automatic stay in the event it filed a petition for relief under the Bankruptcy Code. The lender, in return, agreed to forebear from exercising its remedies while the contractor attempted to generate additional equity for the project. As is often the case, the workout failed and the debtor filed Chapter 11. The lender moved for relief from the automatic stay, which the contractor/debtor unsuccessfully opposed. The court determined that the pre-petition waiver did not violate public policy and, therefore, was enforceable.¹⁹

Nevertheless, not all courts recognize these waivers. On public policy grounds some courts decline to enforce a debtor's pre-petition waiver of the automatic stay.²⁰ Moreover, as the cases make clear, even where the waiver is enforceable and drafted to be self-executing, the surety is strongly advised to move cautiously by seeking to lift the stay where it can argue that,

¹⁷ See T. Scott Leo, "Surety Takeover and the Bankruptcy of the Principal," ABA Tort & Ins. Prac. Section, 2002 Spring Meeting, at 5-6 (May 9, 2002) ("It is unlikely that anyone would challenge the future debtor's waiver of the cure period in the event there is an involuntary bankruptcy filing during what would have been the cure period without the waiver. First, most involuntary bankruptcy petitions involving construction companies end in Chapter 7 liquidations. Second, the debtor has already made the decision pre-petition that it should abandon the contract and let the surety complete. A debtor really cannot be compelled to complete a contract when it has already made the business judgment that the contract should not be completed. Obtaining a voluntary default letter with a waiver of the cure period may help the surety avoid the procedure of lifting the automatic stay in the event of a subsequent filing of an involuntary bankruptcy proceeding.").

¹⁸ *In re Club Tower, L.P.*, 138 B.R. 307 (Bankr. N.D. Ga. 1991).

¹⁹ See also, *In re Powers*, 170 B.R. 480 (Bankr. D. Mass. 1994) (pre-petition waiver of automatic stay was not per se unenforceable); *In re Cheeks*, 167 B.R. 817 (Bankr. D. S.C. 1994) (pre-petition waiver of automatic stay precluded debtor from objecting to creditor's motion for relief from stay); *In re Citadel Props., Inc.*, 86 B.R. 275 (Bankr. M.D. Fla. 1988) (creditor entitled to enforce pre-petition waiver of automatic stay).

²⁰ See *In re Jenkins Court Assocs., Ltd., P'ship*, 181 B.R. 33 (Bankr. E.D. Pa. 1995). See also, *Farm Credit of Cent. Fla. v. Polk*, 160 B.R. 870 (Bankr. M.D. Fla. 1993) (pre-petition waiver unenforceable unless petition was filed in bad faith); *In re Sky Group Int'l, Inc.*, 108 B.R. 86 (Bankr. W.D. Pa. 1989) (pre-petition waiver of automatic stay unenforceable as stay is intended to protect other creditors and therefore debtor alone cannot waive protections of the stay).

among other things, the existence of the pre-petition waiver entitles it to relief. It is risky to proceed without bankruptcy court approval.²¹

iv. Filing the General Indemnity Agreement as a Financing Statement

Sureties do not commonly file the indemnity agreements they secure from principals as UCC-1 financing statements. To do so may interfere with a principal's ability to secure traditional bank financing for its operations. In the normal course, by the time the surety believes it prudent to file the indemnity agreement as a non-conforming UCC-1 financing statement, most of the "horses have left the barn." In other words, there is little in the way of assets for the surety to attach by the filing. By the time a principal is in financial trouble, few of its assets are unencumbered. There may be other challenges to obtaining secured status as well, including a filing less than ninety days before the petition which raises the specter of any security interest arising from the filing being subject to the Code's preference provisions. Additionally, the indemnity agreement may not adequately describe the collateral sought to be secured to make it an enforceable UCC statement. Nevertheless, filing pre-petition is a relatively easy step to take and could result in the surety obtaining a perfected security interest in equipment or other assets that could inure to its benefit in a subsequent bankruptcy filing.

II. Post-Petition Challenges And Options For The Completing Surety

i. Notifying Obligor of Interest in Bonded Contract Funds Prior to Lifting the Automatic Stay

The net cast by the Bankruptcy Code's automatic stay provision is wide. Nevertheless, there is precedent to suggest that the surety may communicate to an obligor its interest in the remaining contract funds on bonded work. It is absolutely critical for the surety to take whatever prudent steps it can to insure that contract funds remain available to pay for contract performance. As a general rule, the automatic stay prohibits the surety from taking overt steps that adversely affect property of the debtor's estate. Of course, if contract funds are not deemed to be "property of the estate" then the surety's actions to secure such funds do not violate the

²¹ See *In re Powers*, 170 B.R. 480 (Bankr. D. Mass. 1994) (motion for relief from the automatic stay is required for enforcement of the pre-petition waiver of stay).

automatic stay. There are numerous decisions to this effect.²² There are, however, decisions to the contrary.²³

Given the uncertainty over whether contract funds are property of the debtor's estate, the surety is cautioned against demanding the obligee take any particular steps with respect to bonded contract proceeds. There is, however, authority that sanctions the surety's notifying bond obligees of its interest in contract funds. The key is to use non-demanding language and set forth in a straightforward informational manner the surety's interests in contract funds. The decision of *In re Hughes-Bechtol, Inc.*,²⁴ is instructive. The surety sent letters to bond obligees that advised them that the principal had failed to pay claims and that those claimants sought recovery from the bonds issued by the surety. The surety further advised that it had paid claims, and therefore believed it had a direct right to the contract proceeds held by the obligees. Moreover, it claimed that, in its opinion, its right to the contract funds was superior to that of the principal and that it might have a claim against an obligee if the contract funds were disbursed or any other action were taken by the obligee that prejudiced the surety's position.

The court determined that this correspondence was primarily informational and, as it was a non-repetitive, single contact by the surety, it would not be considered a violation of the automatic stay.²⁵

ii. Securing Bonded Contract Funds

Money is the lifeblood of any construction project. It is also a critical ingredient to any successful reorganization. Hence the competition over contract funds. Time is of the essence

²² See *Pearlman v. Reliance Ins. Co.*, 317 U.S. 132, 83 S. Ct. 232, 9 L.Ed.2d 190 (1962) (as between the payment bond surety and trustee in bankruptcy, the surety is entitled to receive contract funds to extent necessary to reimburse it for its losses); *In re Modular Structures, Inc.*, 27 F.3d 72 (3rd Cir. 1994) (debtor's failure to pay subcontractors was a breach of contract, entitling the owner to withhold contract monies from the debtor such that the contract balances held by the owner were not property of the debtor's estate); *Merchants Bonding Co. v. Pima County*, 860 P.2d 520 (Ariz. Ct. App. 1993) (same); *In re Pac. Marine Dredging & Constr.*, 79 B.R. 924, 929 (Bankr. D. Or. 1987) ("In short, plaintiff is not contractually obligated to pay the fund to debtor due to debtor's breach of contract. The debtor does not have any legal or equitable interest in the fund. Accordingly, the fund is not property of the estate."); *Universal Bonding Ins. Co. v. Gittens & Sprinkle Enters., Inc.*, 960 F.2d 366 (3rd Cir. 1992) (under state law, money owed to debtor held in trust where debtor owes subcontractors and material suppliers and, as a consequence, funds do not become property of the bankruptcy estate); *Parker v. Klochko Equip. Rental Co.*, 590 F.2d 649 (6th Cir. 1979) (monies held in trust not property of debtor's estate); *Fed. Ins. Co. v. Fifth Third Bank*, 867 F.2d 330 (6th Cir. 1989) (funds held in trust based on provisions in bonded construction cost not property of bankruptcy estate).

²³ See *In re Alliance Props., Inc.*, 104 B.R. 306 (Bankr. S.D. Cal. 1989) (expansive definition of "property of the estate" captured contract proceeds); *In re Glover Constr., Inc.*, 30 B.R. 873 (Bankr. W.D. Ky. 1983) (distinguishing between retainage and unpaid progress payments, although surety's equitable interest in the contract funds afforded adequate protection through joint control of funds and debtor's continuing performance); *In re Ram Constr. Co.*, 32 B.R. 758 (Bankr. W.D. Pa. 1983) (debtor permitted to use progress payments with limitations designed to protect the surety's interest).

²⁴ *In re Hughes-Bechtol, Inc.*, 117 B.R. 890 (Bankr. S.D. Ohio 1990).

²⁵ The case is illustrative because the court attaches copies of the surety's letters as an appendix to its reported decision. As a result, the decision provides a roadmap for sureties placed in similar situations. See also, *Merchants Bonding Co. v. Pima County*, 860 P.2d 510 (Ariz. Ct. App. 1993) (surety's pre-petition request that owner make no further payments to debtor was not a violation of the automatic stay).

and the surety should move quickly to lift the automatic stay to secure its right in contract funds. Under §362(d), a surety may request relief from the stay on grounds that it lacks adequate protection of its interest in the contract funds or that the debtor does not have equity in the contract funds and the funds are not necessary for an effective reorganization.²⁶ The surety has fair number of arrows in its quiver establishing its entitlement to the contract funds, including rights afforded equitable subrogation and trust theories.²⁷

The mechanism for asserting these rights is a motion to lift the automatic stay. This is so even where the law suggests that the contract funds the surety seeks are not property of the debtor's estate. In particular, the surety is advised to quickly move to prohibit or condition the debtor's use of the surety's "cash collateral."²⁸ The surety may, in the alternative, request that the contract funds or "cash collateral" be segregated and the surety afforded "adequate protection" as a condition of the debtor's use of the funds.²⁹ Because cash can be squandered quickly, the surety is best advised to move quickly to secure its cash collateral. Moreover, the matter often comes to a head early because a common first day order is the debtor's request for approval to use cash collateral.

Finally, where the surety has provided bonds on multiple projects for an obligee, some of which are completed for a profit and others at a loss, the surety may wish to consider asserting the owner's set-off rights. Under equitable subrogation law, the surety acquires the obligee's set-off rights enabling it to capture the surpluses on the profitable jobs to set off losses on the unprofitable projects.³⁰

iii. Gaining Control of the Bonded Contracts: The Saga of the Executory Contract

Even if the surety is able to secure the bonded contract funds (or, at a minimum, keep them out of the hands of other creditors), the debtor has an interest in certain contracts either not fully terminated or completed at the time of the filing of the petition in bankruptcy. In the parlance of bankruptcy law, these are known as executory contracts. The law involving executory contracts is anything but clear:

²⁶ 11 U.S.C. § 362(d).

²⁷ See BRUNER & O'CONNOR ON CONSTRUCTION LAW, §12:101 (2002 & Supp. 2008); Leo & Wilson, "Suretyship and the Bankruptcy Code," in THE LAW OF SURETYSHIP, 9-1, 12 (1993); Leo & Wilson, "The 50 Most Important Questions a Surety Can Ask About Bankruptcy," Nos. 8 & 9, Tort & Ins. Prac. Sec. Monograph (1992). See also, RESTATEMENT THIRD, SURETYSHIP AND GUARANTY, §28; RESTATEMENT, SURETY, §141.

²⁸ 11 U.S.C. § 363(e).

²⁹ The form that adequate protection takes will depend upon the circumstances of each particular case. Section 361 of the Code provides that adequate protection, if required, may be provided by the trustee making a cash payment or periodic cash payments; providing an additional replacement lien, or granting such other relief. 11 U.S.C. § 361. See also, *In re Earth Lite, Inc.*, 9 B.R. 440 (Bankr. M.D. Fla. 1981) (equity cushion and personal guaranties offered by principal were insufficient and debtor prohibited from using cash collateral unless it cured its default on the bonded contract and submitted monthly contractual payments); *In re Ram Constr. Co.*, 32 B.R. 758 (Bankr. W.D. Pa. 1983) (debtor required to use progress payments first to pay all claims against the bonded project and only if there was a surplus could funds be used for debtor's operating and overhead expense); *In re Certified Corp.*, 51 B.R. 154 (Bankr. D. Hawaii 1985) (debtor required to grant replacement liens and place all funds received from sale of inventory in a special account with creditor having the right to inspect inventory and receive daily reports).

³⁰ *In re Larbar Corp.*, 177 F.3d 439 (6th Cir. 1999).

Resolution of the [issue] requires us to venture into the thicket that is “executory contracts” where . . . ‘lurks a hopelessly convoluted and contradictory jurisprudence’.”³¹

Section 365 states that the trustee, subject to certain exceptions and subject to the court’s approval, “may assume or reject any executory contract or unexpired lease of the debtor.” If the debtor has already defaulted under the terms of the contract, it “may not assume such contract or lease unless, at the time of the assumption of the contract or lease, the [debtor-in-possession] cures, or provides adequate assurance that [it] will promptly cure, such default.”³² The Code contains no definition of what constitutes an executory contract, and the decisions indicate that a hard and fast definitional rule is not feasible.³³ The tendency of the courts is toward a pragmatic view.³⁴ While there is no clear understanding of what constitutes an executory contract, few would disagree that, notwithstanding the conflicting precedent on this question, an uncompleted construction contract is, in almost all cases, executory.³⁵

³¹ *Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 138 B.R. 687, 689-90 (Bankr. S.D.N.Y. 1992). See also, Carl N. Pickerill, “Executory Contracts Re-Visited,” 83 Am. Bankr. L. J. 63 (2009) (“Section 365 of the United States Bankruptcy Code (the “Code”) constitutes one of, if not the, most convoluted sections of the Code. This section governs the treatment of so-called “executory contracts” in bankruptcy, a topic about which much ink has been spilled within both the academic community and the courts.”).

³² 11 U.S.C. § 365(b).

³³ Every year brings new cases discussing whether or not a particular contractual arrangement is executory. For example, in *In re TS Indus., Inc.*, 117 B.R. 682 (Bankr. D. Utah 1990), a pre-petition workout agreement entered into in anticipation of a bankruptcy filing was an assumable executory contract to extend financial accommodations. As a general rule, however, executory contracts which are deemed financial accommodations cannot be assumed by the debtor. See *In re Sun Runner Marine, Inc.*, 945 F.2d 1089 (9th Cir. 1991) (executory contract which was a financial accommodation could not be assumed by the debtor even with the consent of the lender); *In re Twin City Power Equip., Inc.*, 308 B.R. 898 (Bankr. C.D. Ill. 2004) (financial accommodation contract which was integral, rather than incidental, to an equipment dealership agreement could not be assumed).

³⁴ In recent years, Congress has turned its attention to collective bargaining agreements, technology licenses, and shopping centers as it fine-tunes the law surrounding executory contracts. It has not, however, addressed the core issue of just what the term means. The most widely accepted definition of “executory contract” was offered by Harvard professor, Vern Countryman, in an article published in the *Minnesota Law Review* in 1973:

A contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.

Countryman, “Executory Contracts in Bankruptcy,” 57 MINN. L. REV., 439, 460 (1973). The Eighth Circuit adopted this definition in 1977. See *In re Knutson*, 563 F.2d 916 (8th Cir. 1977). Other courts, depending upon the context, have found the definition either too rigid or inappropriate. See *In re Norquist*, 43 B.R. 224 (Bankr. E.D. Wash. 1984) (medial partnership agreement fully completed except for covenant not to compete was deemed executory, notwithstanding lack of unperformed duties on both sides).

³⁵ See *In re Turbwind, Inc.*, 42 B.R. 579 (Bankr. S.D. Cal. 1984) (agreement for completion of windmill construction project was executory, where debtor’s and defendant’s obligations remained unperformed and rejection of agreement was in best interest of the estate because there was reasonable likelihood that general creditors of estate would derive substantial or significant benefit from proposed rejection); *In re Investors Dev. Co.*, 7 B.R. 772 (Bankr. D. N.J. 1980) (agreement between developer, which posted a performance bond in connection with construction contracts with a township and debtor-in-possession obligating debtor to make improvements under contracts between developer and town, was executory and subject to rejection by debtor); *In re L.D. Patella Constr. Corp.*, 114 B.R. 53 (Bankr. D. N.J. 1990) (contract executed pre-petition by debtor and purchaser was “executory

The interplay between federal bankruptcy law and state law as they relate to executory contracts was discussed in *In re Ravenswood Apartments, Ltd.*,³⁶ where the bankruptcy court denied a motion to compel the debtor to make payments under a land installment contract and to assume or reject the contract within a specified period of time. On appeal, the bankruptcy court's order was reversed and the installment contract was determined to be executory under §365. The debtor purchased an 82-unit apartment in Ohio for \$3.4 million to be paid in monthly installments of \$27,000, with the entire balance due November 1, 2020. Upon payment of the full purchase price, title would be conveyed to the debtor. In reversing the bankruptcy court, the appellate court determined that, under Ohio common law, land installment contracts involved continuing and material obligations to be performed by both parties to the contract and that the failure to transfer title, when promised, or the failure of the land contract purchaser to continue making installments, would constitute a material breach which would permit the other party to avoid continued performance. Applying the Countryman definition, the court held that, unlike in Michigan, land installment contracts governed by Ohio law are executory contracts because both parties have ongoing duties:

Although federal law determines the definition of executory contract for purposes of §365, state law 'determine[s] whether one of the parties' failure to perform its remaining obligations would give rise to a 'material breach' excusing performance by [the] other party.' Therefore, the parties' rights under the contract must be examined under Ohio law.³⁷

One must carefully examine state law if there is some doubt as to whether a contract is executory.

The consequence of declaring a contract executory often confers benefit on the creditor. For example, let us assume the soon-to-be debtor enters into a typical installment sales contract for the purchase of a piece of construction equipment. If the machine costs \$15,000, and the contractor placed \$5,000 down and signed an agreement to pay the balance in \$1,000 installments over ten months with no security given the vendor, few would contest that there is no executory contract to which §365 applies, as the only remaining obligation being a monetary one by the contractor/debtor.³⁸ In this case, the only remedy of the vendor is based upon its unsecured claim for the balance of the purchase price – often an unattractive result for the vendor. On the other hand, if the contract were treated as an executory contract, then presumably the debtor would have to either reject the contract and arguably return the equipment, or assume the contract and pay the full remaining purchase price.

Construction agreements, on the other hand, often present conflicting perspectives as to prospective benefits. Contractors presumably price construction work to incorporate profit and

contract" within meaning of Bankruptcy Code, where house in question was under construction when petition was filed and closing had not occurred).

³⁶ *In re Ravenswood Apartments, Ltd.*, 338 B.R. 307 (6th Cir. BAP 2006).

³⁷ *In re Ravenswood Apartments, Ltd.*, 338 B.R. 307, 312 (6th Cir. BAP 2006) (citations omitted).

³⁸ Contracts where only payment is due are generally not considered executory contracts. *See In re Smith Jones*, 26 B.R. 289 (D. Minn. 1982).

overhead. Unless the contract in question has been heavily front-end loaded, such that little profit remains in the work to be performed at the time of the bankruptcy filing, the contractor may believe the contract holds the prospect of a return of profit. Of course, the fact that the contractor is in bankruptcy suggests that its expectations with respect to profit have been less than entirely accurate. Unless there are some unusual circumstances suggesting that the debtor is uniquely qualified to finish the work, the surety and obligee may legitimately fear the debtor will not be able to cure its defaults (notwithstanding its claims to the contrary) and will continue with sub-par performance. Bankrupt contractors like zombies can wreak havoc wherever they go.

One of the first issues to confront the surety and obligee is the question of timing. A debtor-in-possession or trustee in a Chapter 11 case may assume or reject executory contracts at any time before confirmation of a plan of reorganization.³⁹ Given the predilection of many debtors to simply “let things sit” once the petition has been filed, the obligee and surety will most likely need to shorten the timeframe within which the debtor must make its decision. The Code provides that, if there is cause to lift the automatic stay, unless the party seeking such relief agrees otherwise, the stay will be lifted thirty days after the preliminary hearing.⁴⁰ If the motion is contested, the final hearing for relief must be set within that timeframe.⁴¹ Under §365(d)(2), “any party to an executory contract may request the court to order the trustee to make its determination to assume or reject within a specified period of time. Whether the surety is a “party” to the construction contract is debatable, and, therefore, the obligee should be on board for this motion.⁴²

Given the time-sensitive nature of most construction projects, the surety and obligee should be able to establish the significant harm that delay in the decision to assume or reject will cause them. It should also bring into focus the hurdles the debtor faces if it wishes to assume the contract. Under §365(b), the debtor will need to be able to establish that, at the time of assumption, it has cured or has provided adequate assurance that it will promptly cure, all defaults; has compensated or provides adequate assurance that it will promptly compensate the other party to the contract for its losses due to such defaults; and provides adequate assurance of future performance under the contract.⁴³ This can be a daunting task for many construction company debtors.

Nevertheless, it is important for the surety and obligee to marshal their arguments as the bankruptcy forum is debtor-friendly and the assumption of contracts is often viewed as vital to a debtor’s reorganization efforts. In determining whether to shorten the period of time in which a debtor must assume or reject an executory contract, the courts consider a variety of factors, including:

³⁹ 11 U.S.C. §362(d)(2). By contrast, under Chapter 7, the trustee has sixty days from the date of the bankruptcy filing to assume or reject the contract, or it is deemed rejected after the expiration of the sixty-day period. 11 U.S.C. §365(d)(1).

⁴⁰ 11 U.S.C. §362(a).

⁴¹ 11 U.S.C. §365(d)(2)

⁴² The surety may also want to look at 11 U.S.C. §105(d), which allows any party in interest to seek a conference with the court to discuss the administration of the estate, including the assumption and rejection of executory contracts.

⁴³ 11 U.S.C. §365(b)(1)(A), (B), & (C).

- Ø Importance of the contracts to the debtor's business and reorganization;
- Ø The debtor's failure or inability to satisfy post-petition obligations;
- Ø The nature of the interests at stake;
- Ø The balance of hurt to the litigants and the good to be achieved;
- Ø Whether the debtor has had sufficient time to appraise its financial situation and the potential value of its assets in formulating a plan;
- Ø The safeguard afforded the litigants;
- Ø The damage the non-debtor will suffer beyond the compensation available under the Bankruptcy Code;
- Ø Whether there is a need for judicial determination as to whether an executory contract exists;
- Ø Whether exclusivity has been terminated;
- Ø Whether the action to be taken is so in derogation of Congress's scheme that the court may be said to be arbitrary; and
- Ø The purpose of Chapter 11, which is to permit successful rehabilitation of debtors.⁴⁴

One of the biggest hurdles likely to be encountered by the debtor is the need to provide a surety bond in the event it plans on post-petition performance. This fact provides the surety and obligee with a fair amount of leverage. Because surety bonds are financial accommodations which cannot be assumed by the debtor, it must either convince the surety to continue with surety credit during its post-petition performance or find a substitute surety.⁴⁵ Obtaining new

⁴⁴ See *In re Enron Corp.*, 279 B.R. 695 (Bankr. S.D.N.Y. 2002). See also, Arnold M. Quittner, "Executory Contracts and Leases," in 31st Annual Current Developments in Bankruptcy & Reorganization, Vol. Two at 267 (2009).

⁴⁵ Under §365(c)(2), the trustee may not assume or assign any executory contract where such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor. Surety bonds and surety credit are financial accommodations. See *In re Wegner Farms Co.*, 49 B.R. 440 (Bankr. N.D. Iowa 1985); *In re Thomas B. Hamilton Co.*, 969 F.2d 1013 (11th Cir. 1992); *In re Adana Mortgage Brokers*, 12 B.R. 977 (Bankr. N.D. Ga. 1980); *In re Computer Commc'ns, Inc.*, 824 F.2d 725 (9th Cir. 1987).

There is a split as to whether surety bonds are executory contracts. Compare *In re Evans Prods. Co.*, 91 B.R. 1003 (Bankr. S.D. Fla. 1998) (bond is executory contract) with *In re Gov't. Secs. Corp.*, 111 B.R. 1007 (Bankr. S.D. Fla. 1990), *aff'd* 972 F.2d 328 (11th Cir. 1992), *cert. den.*, 507 U.S. 952 (1993) (surety bond is not executory contract, as only the surety has remaining obligations under the bond). Regardless of whether surety bonds are or are not executory contracts, they are clearly financial accommodations and, as a consequence, cannot be assumed by a trustee or debtor-in-possession.

There is also a split of authority over whether the surety must make a motion to lift the automatic stay in order to cancel its bond. One view is that, because the bond is a financial accommodation which cannot be assumed, there is no need to involve the court. See *In re Sun Runner Marine, Inc.*, 945 F.2d 1089 (9th Cir. 1991). The other view is that, notwithstanding the fact that bonds are financial accommodations, they may be cancelled only upon a motion to lift the automatic stay. See *In re Edwards Mobile Home Sales, Inc.*, 119 Bankr. 857 (Bankr. M.D. Fla. 1990). It is best to proceed cautiously here and seek court approval where there is any doubt on the question.

Still other courts find a third view. See *In re Maxon Eng'g Servs., Inc.*, 324 B.R. 429 (Bankr. D. Puerto Rico 2005) (even assuming, *arguendo*, that payment and performance bond that surety issued in connection with public construction contracts awarded to debtor were in nature of "financial accommodations" so as to except such contracts from general rule that prohibits cancellation or termination of debtor's contracts based on its insolvency or bankruptcy filing, this did not mean that surety could automatically cancel its bonds, but would merely permit enforcement of "*ipso facto*" clause if, and only if, bonds contained such a clause; where bonds did not contain any such clause, surety could not cancel them.)

surety credit for post-petition performance can be a daunting task, and may lead the debtor to think twice before assuming a bonded contract. Nevertheless, debtors have been known to attempt the assumption of bonded contracts, and where the surety and obligee believe this to be a mistake, they will have to oppose the assumption. This was successfully done in *In re C.M. Sys., Inc.*,⁴⁶ where the debtor had not been declared in default before filing its bankruptcy petition. The debtor sought to assume the contract, which the surety and obligee contested. To support their position that the contract should not be assumed, the surety and obligee offered evidence to show that the contractor was behind schedule and that completion of the contract would result in a loss. The court accepted this analysis and denied the debtor's motion to assume, finding that rejection would benefit the estate by reducing claims.⁴⁷

Where a default is non-monetary and not curable, the debtor is precluded from assuming the executory contract if the default was material or if it caused substantial economic detriment. In *In re New Breed Realty Enters., Inc.*,⁴⁸ the debtor had failed to close a sale of common stock. The shares represented all of the issued and outstanding stock in a corporation which was the sole owner of a parcel of residential real property. Debtor had agreed to purchase the property for \$6 million. The debtor was required to deliver \$300,000 by depositing in escrow and the balance of \$5,400,000 at closing. While the debtor made the deposit, it failed to deliver additional funds as required. The agreement provided that time was of the essence. The non-debtor sought relief from the automatic stay because the debtor's time to close the sale under the agreement had expired and the debtor no longer therefore had any interest in the property or in its deposit which was held in escrow.

The debtor contended that it had the right to assume the executory contract and that the 60-day statutory grace period under §108(b) was not relevant because the court had the authority to extend the cure period and furthermore, under §365(d)(2), the debtor was allowed to assume the executory contract at any time before confirmation. The court rejected the debtor's arguments. While the court doubted that there was any power to extend §108 beyond its 60-day period, it noted that the debtor had not made a timely motion to extend it. Moreover, while the contract was an executory contract as of the commencement of the debtor's bankruptcy, the failure of the debtor to close the sale on or before the time of the essence closing date, meant the default could not be cured.⁴⁹

⁴⁶ *In re C.M. Sys., Inc.*, 64 B.R. 363 (Bankr. M.D. Fla. 1986).

⁴⁷ The court also acknowledged that "in the case of a large construction project where there is a payment and performance bond posted, an early takeover of the project by the bonding company may minimize, if not completely eliminate, damage claims." *In re C.M. Sys., Inc.*, 64 B.R. 363, 365 (Bankr. M.D. Fla. 1986). *But see, In re Perretta*, 7 B.R. 103 (Bankr. N.D. Ill. 1980) (a debtor-lessee need not provide adequate assurance of future performance of the lease if it is not in default at the commencement of the proceedings).

There is an additional wrinkle where the owner is the federal government. On federal projects, the government has taken the position that the Federal Acquisition Regulation (FAR), 41 U.S.C. § 15, prohibits the assumption of contracts by a debtor unless the government consents. *See In re West Elec., Inc.*, 852 F.2d 79 (3rd Cir. 1988). The trend is to require the government's consent only where the post-petition debtor is a materially different entity than the pre-petition contractor. *See In re Am. Ship Bldg. Co.*, 164 B.R. 358 (Bankr. M.D. Fla. 1994); *In re Hartec Enters., Inc.*, 117 B.R. 865 (Bankr. W.D. Tex. 1990), *vacated sub nom, U.S. v. Hartec Enters., Inc.*, 130 B.R. 929 (Bankr. W.D. Tex. 1991).

⁴⁸ *In re New Breed Realty Enters., Inc.*, 278 B.R. 314 (Bankr. E.D.N.Y. 2002).

⁴⁹ *See also, In re Clairmont Acquisition Corp., Inc.*, 113 F.3d 1029 (9th Cir. 1997).

If it is critical that work proceed and it is apparent that the debtor will not be able to cure its defaults so as to assume the contracts, the obligee and surety might consider moving to terminate the contract.⁵⁰ If the surety or obligee can establish that completion of the contract will exhaust the remaining contract funds, the court should conclude that the debtor has no interest in the funds and that assuming the contract is of no benefit to the estate. At a minimum, this motion should serve to quickly bring to a head the issues surrounding the debtor's ability to successfully assume and complete the bonded contract.⁵¹

Courts have adopted a number of differing tests for determining the burden a debtor must meet in order to assume a contract. Where the debtor is not in default of the contract a number of courts apply a deferential "business judgment" rule.⁵² Much of the case law dealing with the debtor's business judgment arises in connection with the rejection of contracts.⁵³ Other courts seek to determine if the contract will prove a burden or benefit to the estate.⁵⁴

iv. Securing the Debtor's Subcontractors and Equipment in Aid of Contract Performance

Where the surety and obligee are successful in wresting the bonded contract from the debtor, one of the first issues to be confronted is whether subcontractor performance can be secured. This question raises the issue of the effect of the debtor's rejection of an executory contract. Is the rejection equivalent to a termination of the contract and, in turn, a termination of the debtor's subcontracts? Like so much of the law surrounding executory contracts, there is much murky debate over the issue:

The second issue that has caused great consternation among academics and the courts relates to the consequences of "rejection" of an executory contract. What happens when the debtor-in-possession "rejects" an executory contract? Does the contract just go away? Is the debtor released from all future obligations (yes)? Can the debtor re-obtain rights it relinquished when entering into the contract in the first place (maybe)? Must it continue to adhere to certain promises of

⁵⁰ 11 U.S.C. § 362(d)(1).

⁵¹ See T. Scott Leo, "Surety Takeover and the Bankruptcy of the Principal," ABA Tort & Ins. Prac. Sec., 2002 Spring Meeting (May 9, 2002) ("Where the surety has yet to suffer a loss and wants to seek the termination of the contract, the obligee may be the party with the best standing to assert the contract ought to be terminated because of an event of default. As a party to the contract, the obligee has standing to seek to terminate the stay because of an existing or continuing default on the part of the contract debtor. If the default is serious enough, and it appears the debtor contractor lacks the capacity or ability to complete the work, the owner should proceed to try to terminate the contract by lifting the stay.").

⁵² *In re Huff*, 81 B.R. 531 (Bankr. D. Minn. 1988).

⁵³ See *In re Cirillo*, 121 B.R. 5 (Bankr. D. N.J. 1990) (personal service contract may be rejected if rejection is within the proper exercise of the debtor's business judgment); *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985) (business judgment criteria for rejection is whether the decision is so manifestly unreasonable that it could not be based on sound business judgment); *In re Anglo Energy, Ltd.*, 41 B.R. 337 (Bankr. S.D.N.Y. 1984) (golden parachute employment contracts should not be assumed by debtor unless assumption will benefit the estate even under the relaxed "business judgment" rule).

⁵⁴ See *In re C.M. Sys., Inc.*, 64 B.R. 363 (Bankr. M.D. Fla. 1986).

forbearance to which it agreed when it first entered into the contract (again, maybe)?⁵⁵

A decision that strongly endorses the theory espoused by a number of academics, that rejection is not equivalent to termination, is *In re Couture*,⁵⁶ where the court held that the lease was not terminated when not assumed within sixty days because rejection constitutes a breach and not a termination, and whether the trustee formally abandons the lease or simply fails to assume it, the lease reverts to the debtor.⁵⁷ The court's holding that the rejection of an executory contract does not invalidate or terminate the contract concludes that the primary effect of rejection is that the executory contract at issue is not assumed and the non-debtor party therefore cannot make an administrative claim against the debtor's estate if the debtor fails to fulfill the obligations of the contract.⁵⁸ Under the theory that the debtor's rejection does not amount to termination but simply breach, the surety may be able to successfully assert that its indemnity agreement assigns to it all rights in the subcontracts and their performance is required as long as the surety performs the principal's obligations under the subcontracts.

If the principal/debtor is cooperative, the preferred mechanism is for the debtor to move to assume the executory subcontracts and assign them to the surety.⁵⁹ As a general rule, bankruptcy courts will enforce and assignment, notwithstanding contract provisions to the contrary.⁶⁰ Upon assignment to the surety, the issue of whether existing defaults would be cured

⁵⁵ Carl N. Pickerill, "Executory Contracts Re-Revisited," 83 AM. BANKR. L.J., 63, 64-65 (2009). See also, J. Westbrook, "A Functional Analysis of Executory Contracts," 74 MINN. L. REV. 227 (1989).

⁵⁶ *In re Couture*, 225 B.R. 58 (D. Vt. 1998).

⁵⁷ The court refers to articles by Jay Westbrook and Michael Andrew in reasoning that rejection has no effect upon the contract's existence. The contract is not cancelled, repudiated or rescinded or in any fashion terminated by reason of the rejection. Inasmuch as the lease is not property of the estate once the sixty days has expired, bankruptcy courts generally would grant landlords relief from the stay to exercise their state law remedy of eviction, but the landlord cannot collect the discharged pre-petition rental debt. See also, *In re Bacon*, 212 B.R. 66 (Bankr. E.D. Va. 1997) (rejection is not equivalent to termination); *In re Collins*, 199 B.R. 561 (Bankr. W.D. Pa. 19916) (same); *Foothill Capital V Official Unsecured Creditors Comm. of Midcom Commc'ns, Inc.*, 246 B.R. 296 (E.D. Mich. 2000) (rejection of loan agreement did not necessarily amount to termination which triggers the lender's right to an early termination premium; rejection constitutes a breach which, without more, does not amount to termination); *In re Steaks To Go, Inc.*, 226 B.R. 35 (Bankr. E.D. Mo. 1998) (covenants not to compete in a franchise agreement remain enforceable following the debtor/franchisee's rejection of the franchise agreements as rejection operated as a breach, not as a discharge or extinction of the obligation itself); *In re CVA Gen. Contractors, Inc.*, 267 B.R. 773 (Bankr. W.D. Tex. 2001) (neither expiration of insurance policy period nor §365 rejection terminates the insured's rights and obligations under policy if those rights and obligations arose due to a triggering event prior to the policy's expiration).

⁵⁸ See *In re Brown*, 211 B.R. 183 (Bankr. E.D. Pa. 1997). But see, *In re RBGSC Inv. Corp.*, 244 B.R. 71 (E.D. Pa. 2000) (Chapter 11 debtor was entitled to treat its executory contract as terminated where, due to debtor's rejection of the executory contract, agreement could not be specifically enforced against debtor); *In re Hawaii Dimensions, Inc.*, 47 B.R. 425 (D. Haw. 1985) (rejection of lease of commercial space by debtor-in-possession who did not have funds to keep business open and had not paid landlord in ten months operated to terminate lease); *In re Giles Assocs., Ltd.*, 92 B.R. 695 (W.D. Tex. 1988) (automatic rejection of lease based on debtor's failure to assume or reject lease within sixty days after filing was not merely "breach" of lease, but, rather, terminated lease as to all parties, including secured creditors).

⁵⁹ 11 U.S.C. § 365(f)(2).

⁶⁰ See *In re David Orgell*, 117 B.R. 574 (Bankr. C.D. Cal. 1990) (Code § 365 prohibits the enforcement of a provision in lease that provided for an increase in rent upon assignment of the lease); *In re ANC Rental Corp.*, 278 B.R. 714 (Bankr. D. Del. 2002) (assumption and assignment under §365 not precluded by a statute that is a mere

becomes a more straightforward inquiry, as the surety has the financial wherewithal to make this commitment.

The surety's use of the debtor's equipment presents more of a challenge. Because sureties rarely take any secured interest in their principal's equipment, for the simple reason that lenders generally require a first-lien position, the use of equipment will often require the surety to negotiate with the debtor's lender. In *In re Thayn Farms, Inc.*,⁶¹ the court rejected the debtor's argument that it should be permitted to retain possession of a lessor's equipment and pay an expense of administration only, an amount equal to the actual net dollars benefitting the estate. The court determined that this theory would require it to make an extensive economic analysis of management practices, overhead expenses, weather conditions, and appropriate allocation of other factors, all of which would require the court to engage in much speculation. The court determined that the appropriate expense of administration claim was the reasonable value of the property, regardless of the purpose for which it was used by the debtor.

III. Post-Petition Financing by the Surety

If the principal is cooperative, trustworthy, and possesses peculiar skills or knowledge necessary for the successful accomplishment of the work, the surety may consider some form of post-petition financing to enable the debtor to complete the work. The permutations with respect to debtor-in-possession financing are as myriad as the situations presented. While post-petition is by no means as prevalent as pre-petition financial assistance, in certain cases it may be an attractive alternative. Moreover, while post-petition financing is governed by the bankruptcy law under which special conditions may apply, the underlying analysis of whether to finance or not remains essentially the same. The surety should finance in a post-petition context only if it believes that there exist adequate controls insuring that the financing will reduce its bond obligations more effectively than any other alternative.⁶²

Post-petition financing is largely governed by §364 of the Code. Section 364 permits the trustee or debtor-in-possession to obtain four different types of credit. Section 364(a) allows the

general prohibition where the identity of the contracting party is not crucial to the contract or public safety); *In re Rickel Home Centers, Inc.*, 240 B.R. 826 (D. Del. 1998) (shopping mall lease restricting use of the premises to a home improvement center was a *de facto*, anti-assignment clause and would be stricken). *But see, In re Morgan Sangamon P'ship*, 269 B.R. 652 (Bankr. N.D. Ill. 2001) (individual Chapter 7 debtor's interest in partnership pursuant to an executory partnership agreement was not assumable and assignable by trustee where, under state law, no person could become a member of the partnership without consent of all partners).

⁶¹ *In re Thayn Farms, Inc.*, 117 B.R. 510 (Bankr. D. Neb. 1988).

⁶² In the words of one commentator:

First, the surety decides to finance because it believes that is the cheapest way to get the job done. Otherwise, a course as risky as financing would never be undertaken. Money spent in financing the contractor does not generally reduce the surety's liability under the performance bond, and the cardinal sin of the surety's representative is to do something which renders the surety liable for more than its bond penalty. Therefore, if financing is not the cheapest way to get the job done, or if there is a substantial risk of the surety spending more than its bond penalty, the surety should not be financing. If financing is nonetheless undertaken, the consent of the re-insurers should be obtained.

Gilbert J. Schroeder, "Procedures and Instruments Utilized to Protect the Surety Who Finances a Contractor," 14 Forum 830, 832 (1978-79).

trustee authorized to operate the debtor's business to obtain unsecured credit and secure unsecured debt in the ordinary course of business as an administrative expense, unless the court orders otherwise.⁶³ Typically, §364(a) financing is used for trade credit. Given the priority of an administrative expense claim, it will be paid before general unsecured claims and unsecured priority claims, but after (1) "superpriority" administrative expense claims; (2) secured claims; and (3) administrative expense claims of any superseding Chapter 7 case.⁶⁴ A creditor providing financing pursuant to §364(a) does so at its own risk, as the court may later determine the financing was not obtained "in the ordinary course of business," in which case the creditor would lose its administrative expense claim.⁶⁵

Section 364(b) allows the trustee to incur unsecured debt out of the ordinary course of business after "notice and a hearing."⁶⁶ A "hearing" in this context does not necessarily mean an actual hearing before the court. The Code defines this phrase to mean after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances.⁶⁷ If an interested party does not request a hearing, or there is insufficient time for a hearing, then notice alone is sufficient.⁶⁸ Like §364(a), subsection (b) authorizes the debtor to obtain post-petition financing and incur unsecured debt as an administrative expense under §503(b)(1). While borrowings under §364(a) can be undertaken without court order and without prior notice to the parties in interest, borrowings under §364(b) must be authorized by the court after appropriate notice.⁶⁹ Bankruptcy Rule 9007 addresses the sufficiency of notice. A notice is determined by the court on a case-by-case basis. In some critical situations, courts have upheld short-term telephone notice.⁷⁰ If the emergency, however, appears to have been contrived by the debtor, courts have refused to uphold abbreviated forms of

⁶³ 11 U.S.C. § 364(a). Administrative expenses carry a priority and therefore are carefully monitored by other creditors and require court approval. *See In re Kenney's Franchise Corp.*, 21 B.R. 461 (W.D. Va. 1982) (creditor which, in ordinary course of business, sold merchandise to trustee operating debtor's business was entitled to payment of principal amount of administrative claim for merchandise sold, but was not entitled to recover service charge or late fee allegedly due under state law, where such charges were not authorized by court or trustee and trustee claimed asserted charges were without knowledge or notice of trustee).

The term "ordinary course of business" has been interpreted by some, but not all, courts to require that the debt be incurred in the ordinary course of business both for the debtor and the debtor's line of business. *See P.F. Three Partners v. Emery (In re Upland Partners)*, 208 Fed. Appx. 533 (9th Cir. 2006) (applying vertical and horizontal approach to determine whether unsecured credit is obtained or debt is incurred in the ordinary course of business).

⁶⁴ 11 U.S.C. §§ 503(b), 507(a)(2), and 726(b).

⁶⁵ The term "ordinary course of business" has been interpreted by some, but not all, courts to require that the debt be incurred in the ordinary course of business both for the debtor and the debtor's line of business. *See P.F. Three Partners v. Emery (In re Upland Partners)*, 208 Fed. Appx. 533 (9th Cir. 2006) (applying vertical and horizontal approach to determine whether unsecured credit is obtained or debt is incurred in the ordinary course of business).

⁶⁶ 11 U.S.C. § 364(b).

⁶⁷ 11 U.S.C. § 102(1)(A).

⁶⁸ 11 U.S.C. § 102(B).

⁶⁹ This is also the case with respect to financings under 11 U.S.C. §§364(c) and (d).

⁷⁰ *See In re FCX, Inc.*, 54 B.R. 833 (Bankr. E.D. N.C. 1985) (four days' telephonic and mailgram notice).

notice.⁷¹ Because §364(b) financing does not have to be tied to ordinary business operations, the funds can be used for a variety of circumstances, including funding a liquidation.⁷²

If the debtor can establish that financing is unavailable under §§364(a) and (b), it may move for financing under §364(c). This section provides three different types of protection available for a creditor:

- A creditor may be granted an administrative expense claim with priority over all other administrative expense claims, or a “superpriority” administrative expense claim.⁷³
- The claim can be secured by an asset not already subject to a lien.⁷⁴
- The claim can be secured by a lien junior to an existing lien.⁷⁵

The debtor does not need to establish that it has sought credit from every possible source, but must show that it has made a reasonable effort to seek other sources of available credit under §§364(a) and (b).⁷⁶ The court will not automatically approve the debtor’s financing order, as is evident from *In re Crouse Group, Inc.*,⁷⁷ where a surety sought a superpriority lien in exchange for financing only one payroll period rather than to project completion. The court determined that the proposed financing might well benefit the surety by allowing it to find a replacement contractor, but it did little for the debtor’s estate.

Section 364(d) provides the final level of protection for a party advancing credit to the trustee or debtor-in-possession. The creditor may obtain a senior or equal lien on previously secured property if the court determines that the estate is unable to obtain such credit otherwise and there is adequate protection for the other lienholder.⁷⁸ The concept of “adequate protection” is as important and controversial for debtor-in-possession financings as it is for the use of cash collateral. Where the surety is seeking to finance under §364(d), the tables are turned from its

⁷¹ See *In re Adamson Co.*, 29 B.R. 937 (Bankr. E.D. Va. 1983); *In re Sullivan Ford Sales*, 2 B.R. 350 (Bankr. D. Me. 1980).

⁷² *In re Hartley*, 39 B.R. 273, 278 (Bankr. N.D. Ohio 1984) (trustee in Chapter 7 case granted permission to borrow funds pursuant to §364(b) to pay retainer to attorneys to prosecute preference actions).

⁷³ 11 U.S.C. § 364(c)(1). Courts differ on whether the superpriority administrative expense claim will have priority over the administrative expense claims in a subsequent Chapter 7 case. Compare *In re Energy Coop, Inc.*, 55 B.R. 957, 963 n. 20 (Bankr. N.D. Ill. 1985) with *CitiBank, N.A. v. Transam. Comm. Corp. (In re Sun Runner Marine)*, 134 B.R. 4, 7 (B.A.P. 9th Cir. 1991).

⁷⁴ 11 U.S.C. § 364(c)(2).

⁷⁵ 11 U.S.C. § 364(c)(3).

⁷⁶ See *In re Ames Dept. Stores, Inc.*, 115 B.R. 34 (Bankr. S.D.N.Y. 1990) (superpriority lien granted upon finding that alternative unsecured financing was unavailable and lending arrangement would benefit the estate); *In re Plabell Rubber Prods., Inc.*, 137 B.R. 897 (Bankr. N.D. Ohio 1992) (meeting with one alternative lender was insufficient to demonstrate unavailability of financing).

⁷⁷ *In re Crouse Group, Inc.*, 71 B.R. 544 (Bankr. E.D. Pa. 1987).

⁷⁸ 11 U.S.C. § 364(d). See also, *In re Snowshoe Co.*, 789 F.2d 1085 (4th Cir. 1986) (trustee’s proposed repayment of loan and the existence of an equity cushion in the property was sufficient to satisfy the requirements of §364(d) for a superpriority lien).

perspective as a creditor seeking to protect contract funds by seeking adequate protection for its cash collateral.⁷⁹

Section 361 outlines three forms of “adequate protection.” Because the third category is a “catch-all,” the section does not limit the arrangements that might satisfy the debtor’s obligation to provide adequate protection to appropriate creditors. Typically, the form and amount of adequate protection will be negotiated and memorialized in an adequate protection stipulation or agreed order. Junior lienholders are not entitled to adequate protection as they have no equity interest in the property and would receive no distribution under non-bankruptcy law.⁸⁰

Under §361(1), the single cash payment or periodic cash payments can protect against a decrease in the value of a secured creditor’s interest in property. In practice, this more likely takes the form of periodic cash payments. Section 361(2) permits the trustee to give the existing creditor additional or replacement liens for a decrease in the value of the entity’s interest. Replacement liens can be combined with period cash payments effectively to continue a working capital revolver or similarly structured financing, often on a consensual basis. Section 361(3) is a catch-all which allows the court to “grant such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity’s interest in such property.”⁸¹ The most common form of “indubitable equivalent” is an equity cushion.⁸² Valuing the equity cushion can be an area of dispute. The appropriate valuation methodology can range from fair market value to liquidation value.⁸³ Whether an equity cushion alone will provide adequate protection depends upon the circumstances of the case.⁸⁴

⁷⁹ The Code defines “cash collateral” in §363(a) as follows:

“[c]ash collateral means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in §552(b) of this title, whether existing before or after the commencement of a case under this title.

If requested by a secured creditor, the trustee must provide adequate protection for the use of cash collateral. 11 U.S.C. § 363(e).

⁸⁰ *In re Levitt & Sons, LLC*, 384 B.R. 630 (Bankr. S.D. Fla. 2008).

⁸¹ 11 U.S.C. § 361(3).

⁸² See *In re Gallegos Research Group Corp.*, 193 B.R. 577 (Bankr. D. Colo. 1995) (where value of cushion substantial and sufficient to provide for all of the creditor’s claims, additional protection may not be required).

⁸³ See *In re Penz*, 102 B.R. 826 (Bankr. E.D. Okla. 1989) (applying going concern value); *In re Wendy’s Food Sys., Inc.*, 82 B.R. 898 (Bankr. S.D. Ohio 1988) (going concern value appropriate where essential operating assets sold as an entity); *Ontra, Inc., Wolfe*, 192 B.R. 679 (W.D. Va. 1996) (collateral valuation based on amount realized on collateral arrived at an arm’s length basis); *In re Rash*, 520 U.S. 953 (1997) (cramdown value of Chapter 13 debtor’s truck should be based on truck’s replacement value); *In re Felten*, 95 B.R. 629 (Bankr. N.D. Ohio 1988) (valuation of real estate in rehabilitation is fair market value rather than liquidation value).

⁸⁴ Compare *In re Campbell Sod, Inc.*, 378 B.R. 647 (Bankr. D. Kan. 2007) (where a bank’s collateral likely to increase in value due to working capital infusion provided by new financing, and debtor had a good chance of a successful reorganization, bank was adequately protected by equity cushion) with *In re Strug-Division, LLC*, 380 B.R. 505 (Bankr. N.D. Ill. 2008) (equity cushion alone insufficient to provide existing lender with indubitable

The post-petition financing surety will likely encounter skeptical, if not resisting, creditors where the financing is intended to complete a project which does not demonstrably benefit the estate. The fact that the surety is required to provide financing to complete the project is, in and of itself, suggestive of the fact that completion will not benefit the estate or, at a minimum, the benefit is speculative. In the words of one commentator:

Where the debtor can only prosecute contract work it proposes to assume with the surety's financial assistance, the assumption of the contract may face objections from other parties in the Chapter 11 proceeding. The other creditors will be wary of the assumption by the debtor of contracts, financed by the surety, which will likely yield very little return to the estate. The debtor's resources and personnel should not be devoted to unprofitable or marginally profitable contracts for the sole purpose of reducing the surety's exposure and, consequently, the potential liability of the surety's indemnitors who probably control the debtor's operations. The debtor's application to assume a contract subject to surety financing might, therefore, be viewed by other creditors as a collusive arrangement aimed at reducing the surety's exposure and the indemnitors' potential liability which does not benefit the estate.⁸⁵

equivalent where equity cushion eroded on a daily basis and debtor's potential for successful reorganization was speculative).

⁸⁵ T. Scott Leo, "The Financing Surety and the Chapter 11 Principal," 25 TORT & INS. L.J. 45, 68 (Fall 1990). The author also notes:

The debtor's assumption of a bonded contract results in the debts incurred in the prosecution of the work receiving a priority as expenses of administration, paid in full as part of the debtor's continuing operations. If the contract is marginally profitable then one of the few parties to benefit is the surety, as its exposure is reduced at the expense of other creditors whose debts are subordinate to the administrative expenses incurred to complete the bonded work. This results in a more favorable treatment of the surety than it would otherwise receive as an unsecured creditor. Had the debtor rejected the contract, any claim paid by the surety for completion of the work would have been unsecured.

See also In re Monroe Well Servs., 83 Bankr. 317 (E.D. Pa. 1988); *In re Pac. Express, Inc.*, 780 P.2d 1482 (9th Cir. 1986).

Mr. Leo's thorough article on the subject outlines a number of critical issues the surety should evaluate when examining whether to provide post-petition financing:

1. What steps should be taken to preserve contract balances for the prosecution of the work?
2. What are the claims of third parties to contract funds which should be available for prosecution of bonded contract work?
3. How should contract funds be disbursed to protect the surety's equitable rights and provide for adequate protection?
4. Where the debtor's resources and abilities are required to conclude the work economically, can the assumption of the contract be arranged through surety financing?
5. How can the surety preserve its pre-petition rights against the debtor under the indemnity agreements, including the right to use equipment, inventory, and equipment of the debtor required for the prosecution of the work?
6. After assumption of the contract, how can the surety make sure that the equitable lien against contract funds will continue despite the operation of §552?

Where the surety's financing is likely to provide a substantial benefit to the estate, it is in a better position to seek a superpriority administrative expense under §364(d)(1) or, at a minimum, a priority as an ordinary expense of administration under §507(a)(1).⁸⁶ Notwithstanding the achievement of priority status, the surety will still need to bargain for adequate funds control, including joint control of contract funds and other conditions for the protection of the surety post-petition.⁸⁷

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7. Is the advance of funds by the surety for the prosecution of contract work assumed by the debtor entitled to treatment as a super priority administrative expense claim or as an ordinary expense of administration?

T. Scott Leo, "The Financing Surety and the Chapter 11 Principal," 26 TORT & INS. L.J., 45, 69 (Fall 1990).

⁸⁶ The surety may also consider whether its financing of the debtor provides it sufficient leverage to seek a cross-collateralization clause granting it a security interest in post-petition assets of the bankruptcy estate in order to secure its pre-petition debt. Cross-collateralization is rather controversial, and whereas some courts approve such clauses, others do not. See *In re Beker Indus. Corp.*, 58 B.R. 725 (Bankr. S.D.N.Y. 1986) (approving cross-collateralization); *In re Vanguard Diversified, Inc.*, 31 B.R. 364 (Bankr. E.D.N.Y. 1983) (approving); *In re Flaggstaff Food Serv. Corp.*, 737 F.2d 73 (2nd Cir. 1984) (approving); *Shapiro v. Saybrook Mfg. Co.*, 963 F.2d 1490 (11th Cir. 1992) (disapproving cross-collateralization); *In re Monach Circuit Indus., Inc.*, 41 B.R. 859 (Bankr. E.D. Pa. 1984) (disapproving); *In re Tenney Village*, 104 B.R. 562 (Bankr. E.D. N.J. 1989) (disapproving).

⁸⁷ There are a number of fine articles on the surety's financing option. See George Bachrach and Matthew Silverstein, "Financing the Principal," contained in BOND DEFAULT MANUAL, 3d ed. (ABA Publishing 2005); Charles Langfitt, Bennett Lee and Robert Niesley, "Performance Options Available to the Surety," contained in THE LAW OF PERFORMANCE BONDS, 2d ed. (ABA 2009); Gilbert J. Schroeder, "Procedures and Instruments Utilized to Protect the Surety Who Finances a Contractor," 14 Forum 830, 832 (1978-79).