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## BANKRUPTCY LAW

# Surety's Rights Favored Over Debtor's

Construction lenders must monitor their borrower's contractual performance very closely

By Stephen M. Packman

In 1994, the Third U.S. Circuit Court of Appeals held a construction lender was not entitled to contract proceeds due from its borrower as a result of the borrower's default under the construction contract and competing claims to the funds by its surety. *In re Modular Structures, Inc.*, 27 F.3d 72 (3rd Cir. 1994). The decision in *Modular* continues to affect the business of contractors, secured construction lenders and sureties. Since *Modular* was decided, several courts in the Third Circuit and other jurisdictions have relied upon the rationale of *Modular* in reaching decisions which have typically, but not uniformly, favored the surety's rights over those of the debtor and its secured lender. Many of these decisions appear to go even further beyond the scope of the court's decision in *Modular*.

The debtor in *Modular* was a general contractor that had contracted to build the Salvation Army a new corporate headquarters in New Jersey. The bank in *Modular* had loaned the debtor \$1.5 mil-

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*Packman is a shareholder with Archer & Greiner of Haddonfield and the chair of its debtor and creditors' rights group.*

lion prepetition, part of which was used by the debtor on the Salvation Army project. Following the debtor's Chapter 7 filing, the bank pursued collection of the debtor's accounts receivable. The bank made a demand on the Salvation Army for payments due on the contract. The Salvation Army refused payment to the bank. The bank then moved before the bankruptcy court for turnover of the proceeds of the contract.

The bonding company in *Modular* cross-moved for an order requiring the proceeds of the contract to be placed in escrow to assure that sufficient funds would be available to pay subcontractors. The bonding company argued that the proceeds of the contract did not constitute an account due to the debtor and secured by the bank's lien. In support, the bonding company noted the written terms of the contract wherein the debtor agreed that it would not be entitled to payment until it paid its subcontractors. The bankruptcy court awarded turnover of the retainage amounts held under the contract to the bank. The bonding company then appealed to the district court, which affirmed the bankruptcy court's decision.

The bankruptcy court based its decision in *Modular* largely upon the fact that the contract was a private contract. Prior to *Modular*, the leading case on the topic

was decided by the U.S. Supreme Court in *Pearlman v. Reliance Insurance Company*, 371 U.S. 132 (1962). *Pearlman* involved a public contract dispute between the bankruptcy trustee of a government contractor and the contractor's payment bond surety. At the time of the bankruptcy filing, the government was holding \$83,735.35 in funds that would have been paid to the contractor under the prevailing contract had it paid its subcontractors. The surety had paid in excess of \$300,000 in subcontractors' claims as a result of the debtor's default under its contract with the government. Relying on its subrogation rights, the surety made a claim to the funds withheld by the government under the contract.

The bankruptcy trustee in *Pearlman* argued that the funds under the contract were property of the bankruptcy estate. *Pearlman* was decided under the bankruptcy act. Under the current Bankruptcy Code, the bankruptcy estate of the debtor consists of all legal and equitable interest of the debtor as of the petition date. 11 U.S.C. 541(a). However, to the extent the debtor holds only legal title to an asset, but not an equitable interest, only the legal interest becomes part of the estate. 11 U.S.C. 541(d). The surety in *Pearlman* argued that its "equitable lien rights" superceded any legal right of the debtor in

the contract proceeds.

The Supreme Court agreed with the surety, holding that if the surety had an equitable lien right prior to the debtors' in the funds, then the funds never became part of the bankruptcy estate to be administered and distributed to creditors. *Id.* at 136. The Court relied upon its prior decision in *Henningsen v. United States Fidelity & Guaranty Co.*, 208 U.S. 404 (1908), which held that the "government had a right to use the retained funds to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of the fund; that the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the fund; and that the surety, having paid the laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it." *Id.* at 141-42.

In reversing the bankruptcy and district courts, the Third Circuit in *Modular* declined to distinguish between government and private contracts. "[T]he equitable obligation of the owner to pay subcontractors from contract funds remaining in the owner's hands is not confined to government projects, (citations omitted)." *Modular*, at 79. Accordingly, the withheld contract funds were not property of the debtor's bankruptcy estate since it had breached its contract with the Salvation Army prior to filing bankruptcy. As a result, the funds were not property of the debtor's bankruptcy estate and the bank's lien rights did not attach to the funds. *Id.* at 80.

In deciding *Modular*, the Third Circuit clearly adopted the equitable subrogation doctrine posited by the Supreme Court in *Pearlman*. However, the *Modular* court appeared to place considerably greater emphasis on the terms of the contract that specifically required the debtor pay its subcontractors prior to the contract being deemed completed. *Modular*, at 75. The court noted that its decision in *Gittens & Sprinkles, Ent., Inc.*, 960 F.2d 366 (3rd Cir. 1992), did not undercut its decision in *Modular*. "In contrast to the situation in *Gittens*, in the present case, because of *Modular*'s failure to pay its subcontractors, *Modular* was not "owed" the monies held by the Salvation

Army." *Modular*, at 79. If the funds had been owed to *Modular*, they would have become accounts under New Jersey law. *Id.*; *Continental Finance*, 241 A.2d at 860. The Third Circuit remanded the proceedings to the bankruptcy court to determine the extent to which subcontractors remained unpaid. *Id.* at 80.

The courts have struggled since *Modular* in applying its basic tenet to varying situations. For instance, what if the funds due under the contract are deemed progress payments and not retainage? Two courts since *Modular* have broached this issue. The United States Bankruptcy Court for the Eastern District of New York noted that the "distinction between a dispute involving contract retainage after the debtor-contractor's pre-petition default (the *Pearlman* situation) and one involving progress payments to a performing debtor-contractor (the *Glover* situation), is real; this case involves the former." *In re QC Piping Installations, Inc.*, 225 B.R. 553, 568 (Bankr. E.D.N.Y. 1998). See, *In re Construction Alternatives, Inc.*, 2 F.3d 670 (6th Cir. 1993) (holding that the debtor-contractor had an interest in the final progress payment due under a contract despite the surety's payments to subcontractors and the progress payment was therefore property of the estate).

The court in *QC Piping* stated that it was "undisputed that the work on the project was complete at the time that [the debtor] petitioned for bankruptcy. ... [t]here were several bookkeeping and administrative matters ... to be completed, and several subcontractors to be paid, but [the debtor] owed nothing to the [project owner] and therefore, no payments to the [project owner] were required, or other expenses incurred to perfect [the debtor's] claim to the final progress payment... Thus, we conclude that the debtor had earned its right to the final progress payment ... " *Construction Alternatives*, at 674; *In re Wm. Cargile Contractor, Inc.*, 203 B.R. 644 (Bankr. S.D. Ohio 1996).

It is not clear why *QC Piping* distinguished the final progress payment from a retainage payment such as the one at issue in *Modular*. In *Modular*, administrative matters such as architect certifications

remained to be completed as well as the payment of the subcontractors.

Depending upon the jurisdiction, then, it seems that the language of the underlying construction contract carries considerable weight in determining whether a debtor or its secured lender are entitled to payment. The Third Circuit refused to adopt the rationale in *QC Piping* in its 2003 decision in *Caribbean Resort Construction and Maintenance, Inc.*, 2003 WL 23940300 (Bankr. D. Puerto Rico). Whether or not the payments to the suppliers are deemed progress payments or retainage, the debtor did not perform under its contract, and thus the moneys retained by the principal for the payment of unpaid suppliers are not property of the estate. *Id.* at 9. Further questions arise where there is no integrated written contract or where the debtor elects to attempt postpetition performance under the contract despite a prepetition default.

The bankruptcy court in the matter of *In re Christopher Todd Whiteman d/b/a CTW*, 1997 WL 770422 (Bankr. E.D. Pa. 1997), ruled that *Modular* and *Pearlman* do not apply at all in a case where there is no written contract between the project owner and the debtor. The court was "unable to ascertain any common law principles which would give Pizolato, as subcontractor, any rights to the funds in the hands of Brandywine [the project owner] superior to that of the Debtor." *Id.* This holding appears to be contrary to *Modular* and *Caribbean* where the Third Circuit premised its decisions, in part, upon the common law equitable principle of subrogation enunciated by the Supreme Court in *Pearlman*.

The issues are further complicated where the debtor is a contractor reorganizing under Chapter 11 of the Bankruptcy Code. Under section 365 of the Bankruptcy Code the debtor has the right to assume an executory contract by performing under the contract and curing all prepetition defaults at or prior to plan confirmation. The debtor should be permitted to cure defaults relating to nonpayment of subcontractors where the debtor seeks to perform on the construction contract. See, generally, *D&D Associates, Inc. v. The North Plainfield Board of*

*Education*, 2004 WL 2558378 (D.N.J. 2004). The debtor may very well perform during the reorganization and at some point cure its prepetition defaults. However, the project owner will understandably be reluctant to make progress payments to the debtor where the prepetition claims of the surety and subcontractors remain unpaid, particularly where claims of others providing services and goods during the reorganization may take precedence over those unpaid claims. Prepetition subcontractors may not be willing to complete the project. Many will look to the project owner, the project itself and/or surety for payment. This often forces the debtor to obtain injunctive relief from the bankruptcy court in order to reorganize.

Problems with *Modular* have also surfaced where sureties and other claimants have asserted rights to payments or other assets that do not necessarily arise under the contract with the debtor. In the matter of *In re Garomon*, the bankruptcy court in New Jersey determined that the underlying construction contract gave the surety indemnification claims against the contractor's principals to the extent that subcontractors and materialmen were not paid on bonded projects. *In re Garomon*, 2003 WL 23973174 (2003). The court held that the surety was subrogated and given the same trust fund priority as those claimants (subcontractors) had in the bonded contract proceeds which were subsequently used toward the purchase of the debtor's island house. Id.

The court in *Garomon* held that the debtor's home could be sold so that the parties might then assert their lien rights and claims against the asset. Id. The court did not decide the issue of whether the surety's trust fund claim arising under *Modular* and *Pearlman* would extend to an asset purchased with the trust funds. It would seem that the surety's trust fund

claim to the contract proceeds would not extend under *Modular* beyond the trust once the res of the trust is dissipated. The surety might have a fraudulent conveyance claim, however, against the asset based upon its equitable lien rights arising under *Pearlman*.

In *Enron Corp.*, 307 B.R. 372 (Bankr. S.D.N.Y. 2004), the U.S. District Court affirmed the bankruptcy court's ruling denying the surety's equitable subrogation claim against excess collateral held in the bankrupt obligor's margin account. The district court noted that under *Pearlman*, "subrogation places the surety in the position to exercise the debtor's rights to identifiable contract funds, effectively removing the property from the estate and rendering it unavailable to general creditors." Id. (citing *In re Alcon Demolition, Inc.*, 204 B.R. 440, 447-48 (Bankr. D.N.J. 1997).

The bankruptcy court, however, found that under the contract at issue, the obligee paid by the surety had no right to look beyond the strict terms of the contract that did not provide a right of the obligee to look to excess collateral in the margin account to satisfy the debtor's obligations in default. Id. at 380. Accordingly, the surety had no equitable right to that collateral merely by standing in the shoes of the obligee by way of subrogation. Id. The court distinguished the case from *Alcon* where the "arbitration award owed to the debtor, and through subrogation to the surety, was not a pre-existing property interest, but a payment arising from (and now owing to the debtor from) the wrongful termination of the contract." Id. at 382, *Alcon* 448.

In *Alcon*, prior to the contractor's bankruptcy filing under Chapter 11, the surety paid the debtor's subcontractors on a defaulted job. The troubling issue for the court was in determining whether the arbitration award to the debtor in its suit

against the owner of a project was in fact a proceed of the contract which would place it beyond the reach of the debtor's bankruptcy estate to the extent of the surety's *Pearlman* claim. In other words, was the award part of the trust claim of the surety? *Alcon*, at 449. The bankruptcy court in *Alcon* held that since the debtor included payments made under the performance bond as evidence of damages in its arbitration case, the arbitration award was clearly money due under the contract and therefore part of the trust res. Id.

It is not clear from the decision whether the underlying contract in *Alcon* actually gave the unpaid materialmen (and therefore the surety by subrogation) a right to the arbitration award prior to that of the debtor.

The most significant impact of *Modular* has been upon construction lenders who must now monitor their borrower's contractual performance very closely to avoid risk of prior equitable liens arising. A prudent lender will require updated payable agings from the borrower on a frequent basis. It will also require the borrower to certify regularly that no bond or similar claims have been made on a project.

In fact, significant issues under *Modular* remain undecided. For instance, what will happen to payments received by a lender prior to the debtor's bankruptcy where the subcontractors remained unpaid at the time of the payments to the lender? Under *Modular* and *Carribean*, the lender may not have held a lien on those funds when paid. A trustee might seek to set aside those transfers (assuming that a surety or other party did not have a prior claim to them) as preferential for the benefit of unsecured claimants. Whatever the future issues may be under *Modular*, clearly the *Modular* effect will continue in many contractor bankruptcy proceedings. ■