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ALERT

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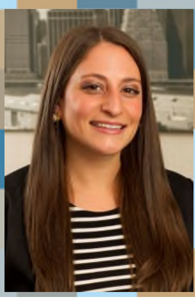

Lauren Bernstein

Bankruptcy Court Determines That The Right Of A Surety To Recover Retainage In A Construction Contract Due To Equitable Subrogation Is Superior To A Creditor's Security Interest Even If Perfected

On July 2, 2019, the United States Bankruptcy Court for the Southern District of Mississippi sent a clear message to secured lenders that their security interests on a contractor's account receivables, even if perfected, will not be superior to the rights of a surety to recover retainage[1] during a bankruptcy proceeding. The decision presents an important take away for secured lenders-- if a construction project is incomplete, securing their loan solely with a security interest in a contractor's accounts receivables is a risky decision.

In *In re Kappa*, Case No. 17-5115-KMS, a general contractor (the "Debtor") filed a voluntary petition for relief under Chapter 11 of Title 11 of the United States Bankruptcy Code (the "Petition"). Prior to filing the Petition, the Debtor executed a promissory note (the "Note") to its bank (the "Bank"). In connection with the Note, the Debtor executed a security agreement which provided the Bank a secured interest in a plethora of collateral including the Debtor's accounts receivables. The Bank properly perfected its security interest in or about September 2010. The Debtor ultimately defaulted under the Note.

In 2014 and 2015, the Debtor entered into two government contracts to complete construction projects. A surety company (the "Surety") issued payment and performance bonds on the Debtor's behalf To insure the Debtor's performance under the government contracts. The Debtor subsequently failed to pay several subcontractors, suppliers and its premium for its workers' compensation insurance coverage which were ultimately paid by the Surety. The Surety sought to recover the payments it had made on the Debtor's behalf.

Prior to and during the bankruptcy, the Debtor received final payments from the owners of the two construction projects (the "Disputed Funds"). Both the Bank and the Surety claimed they were entitled to the Disputed Funds.

In its decision, the Court clearly stated that equitable subrogation is not governed by the priority rules set forth in the Uniform Commercial Code and that equitable subrogation will apply "whenever any person, other than a mere volunteer, pays a debt or demand which in equity and good conscience should have been paid by another…" (internal citations omitted).

In order to determine whether the Bank or the Surety was entitled to the Disputed Funds, the Court had to first determine whether the Surety's payments were elective in that it was legally obligated to make the payments, whether the Disputed Funds were in fact retainage rather than progress

[1] Retainage is a portion of a construction contract's final payment that is withheld by the client until the construction project is complete.

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This Alert was written by Lauren Bernstein.

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payments which would not have created a right to equitable subrogation and whether the Debtor had any right in the Disputed Funds.

The Court held there was no question that the Surety was legally obligated to make the payments and that the Disputed Funds were in fact retainage and not progress payments. Additionally, in applying both federal and state law, the Court determined that the Debtor did not have any right in the Disputed Funds - the portion of the Disputed Funds that was received prior to the Petition was never part of the bankruptcy estate, and the portion of the Disputed Funds that was received after the Petition, only became property of the bankruptcy estate subject to the Surety's right of equitable subrogation. The Court emphatically stated that the Surety's "right of equitable subrogation [] was unaffected by [the Bank's] perfection of [] its security interest" and "the overwhelming weight of case law favors the surety for retainage regardless of whether the bonds were executed before the financer's security interest was perfected."

While this decision was based, in part, on Mississippi law, the Court makes it clear that its holding applies across jurisdictions. Thus, a secured lenders' right to recover from a contractor's accounts receivable based upon a perfected lien is now jeopardized by the rights of a surety due to the doctrine of equitable subrogation and lenders should be diligent in monitoring their collateral coverage.

Any issues raised in this Alert may be addressed to Ms. Bernstein who can be reached at (516) 873-2000 or by email at lbernstein@moritthock.com.

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