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SURETY LAW

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By: Keith Langley

Equitable subrogation is a powerful concept. Especially when powerful people, namely the United States Supreme Court, says the surety on a bond is entitled to be equitably subrogated to the funds otherwise due the contractor by the government. *Pearlman v. Reliance Insurance Company*, 371 U.S. 132 (1962). In the Pearlman case the government had already paid the funds to the bankruptcy trustee and the Court said “no you have to pay the surety”. All of this happened in 1962. Along comes a challenge suggesting Pearlman is no longer good law. The concept of being in the shoes of the party paying is powerful. This is a good time to again review the Pearlman case and shout it from the rooftops.

In Pearlman, the surety made payments to folks performing labor and providing materials for the project. The government then took the contract funds and paid them to the bankruptcy trustee Pearlman who argued that the fund was “property of the bankrupt estate” and had vested in the trustee by operation of law under the Bankruptcy Act. Reliance Surety argued there was no vesting in the trustee. Trustee Pearlman argued under *Munsey Trust* that the surety had no superior rights in the fund and that the surety was entitled to only an unsecured bankruptcy claim. The District Court held against Pearlman, the Second Circuit affirmed, and based upon a conflict in the circuits the Supreme Court granted certiorari.

The Court determined that the contract balance was "other people's money". Being OPM, the funds were not property of the estate. These property rights of the surety existed before bankruptcy and the rights of the surety had to be recognized and respected in the bankruptcy. Accordingly, the question became whether Reliance Surety had ownership of, or prior rights to the fund.

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We hope that these changes make big differences in the future.

Well done is better than well said.

- Benjamin Franklin

The Court determined that a surety who pays the debts of another is entitled to all of the rights of the person he paid to enforce his right to be reimbursed, calling this the right of subrogation, citing *Prairie State Bank* and *Henningsen*. So the surety is on first! The Court discussed the equities and found an equitable right to the retained fund. Since the government had a right to use the retained fund to pay folks who provided labor and material, who had a right to be paid out of the fund, and the surety having paid these folks, was entitled to the benefit of all of these rights necessary to reimburse it.

The Pearlman decision is short and very powerful.

The IRS in a much more recent case argued that Pearlman was no longer good law with the passage of the Bankruptcy Code. It was and it is good (even great) law! *American States Insurance Company v. U.S.*, 324 B.R. 600 (N.D. Tex. 2005). The IRS argued that it was in first place ahead of the surety in the *American States Insurance* case. The general contractor Manhattan wanted to pay the debtor, with the money then going to the IRS. Once again, the concept of equitable subrogation and the concept of Pearlman were reaffirmed. Pearlman lives on despite the passage of the Bankruptcy Code. We were faced with all of the arguments and once again the principles of equitable subrogation prevailed. The Court held that Pearlman survived the Bankruptcy Code passage, that a surety's equitable subrogation right is not a "claim", and concluded that the bankruptcy court orders vesting the property in the debtor were erroneous and vacated. Accordingly, the surety was able to receive the funds and the bankruptcy automatic stay was lifted to allow the surety to execute upon the funds. It is good to be on first.

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