

UNITED STATES BANKRUPTCY COURT

DISTRICT OF SOUTH DAKOTA

ROOM 211

FEDERAL BUILDING AND U.S. POST OFFICE

225 SOUTH PIERRE STREET

PIERRE, SOUTH DAKOTA 57501-2463

IRVIN N. HOYT
BANKRUPTCY JUDGE

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February 2, 1990

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Re: Robert Allen & Elsie J. Bak
d/b/a Bak Construction Company
Chapter 11 386-00049
Adversary 88-3003

Dear Counsel:

The Court has before it First Fidelity Bank of Murdo's complaint and United States Fidelity and Guaranty Company's cross-claim and counterclaim, all relating to debtors Robert and Elsie Baks' debtor-in-possession account for the City of Estelline Waste Water Treatment Project and certain materials purchased for that project. First Fidelity and USF&G each claim to have a superior interest in the DIP account funds and the property.

The parties have agreed to stipulate to the facts. On June 12, 1981, USF&G and Bak Construction entered into a master surety agreement. On September 18, 1984, Bak contracted with the City of Estelline to perform certain waste water treatment improvements (EPA Project C460393-03). Pursuant to the master surety agreement, USF&G provided a performance bond and a payment bond for Bak, which bound USF&G as Baks' surety on the Estelline project. On August 12, 1985, Bak executed an assignment in favor of First Fidelity Bank of Murdo for all payments then due or that would become due to Bak in connection with the Estelline project. The assignment was provided to First Fidelity as partial security for certain indebtedness due to the bank by Bak. The City of Estelline consented to the assignment on August 22, 1985.

Re: Robert & Elsie Bak
February 2, 1990
Page 2

First Fidelity has possessed a valid, perfected security agreement in Baks' machinery and equipment since 1972. First Fidelity filed an amended financing statement with the South Dakota Secretary of State on August 16, 1985, perfecting a security interest in all contract rights and accounts held by Bak, as well as a certain collateral note secured by a real estate mortgage.

While Bak was working on the Estelline project, numerous materialman's claims were filed with the city for work done and materials furnished to Bak relative to the project. The city, in January 1986, wrote Bak concerning these claims and the possibility of withholding further payments on the project. As of February 1986, over \$116,000.00 remained unpaid to Baks' suppliers. The city later informed USF&G that, as Baks' surety, it might ultimately be responsible for Baks' unpaid debts on the Estelline project. After various claims had been filed with USF&G, the company demanded that Bak provide funds to indemnify it from eminent loss on the bond. Baks' failure to pay several subcontractors and suppliers resulted in USF&G being required to pay such debts pursuant to the payment bond.

On June 22, 1986, Baks, d/b/a Bob Bak Construction, filed for protection under Chapter 11 of the Bankruptcy Code. Schedule B-4 showed the funds from the Estelline project as having been assigned to First Fidelity. The establishment of two debtor-in-possession accounts was ordered by the Court¹ on July 22, 1986. One account was specifically for funds derived from the Estelline project.

On January 7, 1987, the City of Estelline notified Bak that it was terminating its contract with him for the waste water treatment project. Bak, on May 1, 1987, was allowed by the Court to reject the contract with the city. USF&G, by terms of the performance bond, was bound to complete the Estelline project. USF&G and the city thereafter contracted with Prunty Construction for the completion of the project. At that time, the unpaid balance under the original contract with Bak was \$234,909.21. The contract for completing the project by Prunty totaled \$326,000.00, exceeding the unpaid balance due Bak by \$91,000.00. Prunty completed the project, including the installation of a generator and pipe that had previously been purchased by Bak and left at the construction site. USF&G paid Prunty Construction more than \$368,000.00 to Complete the Estelline project.

On January 21, 1988, the present adversary was commenced by First Fidelity to determine the validity, priority and extent of the lien and claims on the remaining funds in the DIP account

¹ The Honorable Peder K. Ecker presiding.

established for the Estelline project.² First Fidelity's adversary asked for a similar determination regarding the generator and pipe left by Bak at the project site. USF&G responded with a cross-claim and counterclaim asserting that it has a prior, superior interest in the funds, generator and pipe. Discovery was taken, including the deposition of co-debtor Elsie Bak, the construction company's bookkeeper. The Court wrote counsel, setting a briefing schedule and framing the issues to be briefed. This is a core proceeding under 28 U.S.C. § 157(b)(2)(K). This memorandum constitutes the Court's findings of fact and conclusions of law pursuant to Bankruptcy Rule 7052 and Federal Rule of Civil Procedure 52.

I.

WHETHER USF&G, AS SURETY, OR FIRST FIDELITY, AS ASSIGNEE, IS ENTITLED TO THE FUNDS DEPOSITED IN BAKS' DEBTOR-IN-POSSESSION ACCOUNT FOR THE ESTELLINE PROJECT.

First Fidelity claims that it is entitled to the funds in Baks' DIP account for the Estelline project, relying on *Aetna Casualty & Sur. Co. v. J.F. Brunken & Son, Inc.*, 357 F. Supp. 290 (D.S.D. 1973). In *Brunken*, Aetna brought a declaratory judgment action to determine the priorities between conflicting claimants as to the property of the Brunken Company or the proceeds thereof after Brunken had been put into receivership. The National Bank of South Dakota (NBSD) and Northwestern National Bank (NWB) both asserted security interests in the Brunken proceeds under the Uniform Commercial Code as adopted in South Dakota.

Brunken had contracted for certain construction projects and Aetna furnished the performance bonds for such projects between 1967 and 1970. Under the terms of the bond application, Brunken assigned to Aetna

all rights, title and interest in and to all tools, plant, equipment, and materials of every nature and description that the said (Brunken) may now or hereafter have upon said work, or in or about the site thereof, or used in connection with the work and located elsewhere [.]

Aetna was later called upon to perform on the bond and complete four of Brunken's projects at a deficit of \$302,366.45 to the surety.

² A previous adversary determined that USF&G was entitled to the balance due Bak for work performed or to be performed on the project, but which had been withheld by the City of Estelline.

NBSD had established a line of credit with Brunken since 1955 and had provided Brunken with the necessary financing for equipment purchases. In January 1968, Brunken entered into a security agreement with NBSD that listed certain items of collateral and contained an after acquired property clause. The security agreement and financing statement were duly filed with the South Dakota Secretary of State and NBSD loaned Brunken additional funds in reliance thereupon. Brunken defaulted on this obligation to NBSD, leading the bank to demand and receive possession of the collateral. A receiver obtained the assets before NBSD could dispose of them.

NWB likewise lent Brunken money in April 1970 and had filed a financing statement with the Secretary of State. However, NWB conceded that the demands made by Aetna, NBSD and NWB exceeded the funds in the possession of the receiver, which totaled \$142,149.02.

Aetna asserted that it did not need to perfect its interest by filing in order to prevail over the banks. It contended that its obligation as a surety constituted an equitable lien that related back to the date the surety agreement was signed. Alternatively, Aetna contended that if its claim was found to be a security interest, it must considered a contract right to an assignee who is also to perform under the contract and that it was expressly excluded from the provisions of the Uniform Commercial Code under U.C.C. § 9-104(f).³

The district court was not persuaded by Aetna's argument that the court should "extend the established priority it [the surety] has been provided by law in the defaulting contractor's retained

³ U.C.C. 9-104 as enacted in South Dakota in 1967 and codified at SDCL 57-34-14 provided:

This sub-title does not apply

. . .

(f) to a sale of accounts, contract rights or chattel paper as part of a sale of the business out of which they arose, or an assignment of accounts, contract rights or chattel paper which is for the purpose of collection only, or a or a transfer of a contract right to an assignee who is also to do the performance under the contract[.]

It should be noted that South Dakota has since amended this section to reflect the 1972 revisions of the U.C.C. and recodified this section at SDCL 57A-9-104.

Re: Robert & Elsie Bak
February 2, 1990
Page 5

proceeds to the same superior position in the defunct contractor's personal property." *Id.* at 293. The court found that the practical consequence of Aetna's theory was "nothing less than an appropriation of a secured creditor's collateral to reimburse the performing surety" and that an unsecured surety does not acquire priority in a defaulting principal's personal property over secured creditors whose interests have been perfected in compliance with the U.C.C. *Id.* at 293, 294. The court also held that Brunken's performance bond application did not convey a contract right to Aetna but rather an interest in personal property as security to reimburse Aetna should it be called upon to perform. Such an interest falls within the scope of Article 9 and the court held that Aetna failed to comply with Article 9's provisions.

First Fidelity argues that *Brunken* is applicable to the present case, alleging that *Brunken* specifically limited the superior right of an equitable lien claimed by a surety to situations where the property owner had retained payments under the contract. Relying on *Brunken*, First Fidelity thus argues that USF&G would have no claim to the proceeds in Baks' DIP account for the Estelline project because those funds represented payment for work actually completed prior to defaulting on the contract. Because the funds in the DIP account were not retained, First Fidelity argues that its perfected security interest in those funds is superior to any interest alleged by USF&G.

USF&G asserts that *Brunken* is inapposite, noting that the nature of the collateral in *Brunken* was personal property subject to a valid, perfected security interest. By contrast, the alleged collateral in the present case is funds deposited in a special account that Judge Ecker ordered to be established. USF&G claims that the order, not the holding in *Brunken*, governs who has priority to the funds. The order for cash collateral, entered by Judge Ecker on July 22, 1986, stated in part:

Debtors shall have two (2) D.I.P. checking accounts, that one of these accounts shall be used solely for the City of Estelline project, that Debtors shall deposit all sums from the City of Estelline project into the account, that Debtors shall write checks only for the City of Estelline project from that account, that the bank shall be notified when the account is opened that T.F. Martin, attorney for the City of Estelline and Eugene Mayer, attorney for U.S.F. & G., shall receive a copy of the bank statement, that Debtors shall additionally annotate his copy of the bank statement to explain all deposits and checks written, a copy of which annotated statement shall be immediately provided to the attorneys for the City of Estelline and U.S.F. & G.

Re: Robert & Elsie Bak
February 2, 1990
Page 6

The Court agrees with USF&G that the holding in *Brunken* does not govern the issue of who is entitled to the funds in the segregated DIP account. Here, unlike *Brunken*, the collateral in question is not personal property that is subject to a valid, perfected security interest. Rather the collateral in the present case is funds placed in a segregated DIP account, established by order of the Court and to be used solely for the Estelline project. While the holding in *Brunken* limits the superior right of a surety to payments retained by the contract holder, it did not contemplate a situation where, as here, a special account was established for the contract project and where the only deposits or withdrawals from that account had to relate to that project. Here, the DIP account for the Estelline Project contains funds paid to Bak by the City of Estelline and such funds could only be used to pay those costs incurred for the Estelline project.

Having determined that *Brunken* is inapposite, the question that next arises is whether USF&G is entitled to the funds in the segregated DIP account under the doctrine of equitable subrogation. See *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 83 5. Ct. 232 (1962), and *National Shawmut Bank of Boston v. New Amsterdam Casualty Co.*, 411 F.2d 843 (1st Cir. 1969). The equitable doctrine of subrogation

is grounded on the principle that when one, not a volunteer, pursuant to an obligation, fulfills the duty of another, he is entitled to assert the rights of that other against a third party. By paying the contractor's debts, the surety acquires the right of substitution to the position of the contractor's creditors when he pays. The doctrine does not arise from any specific contractual provision but is an assignment created by operation of law to prevent unjust enrichment.

Brunken, supra at 293 (quoting Comment, Equitable Subrogation - Too Hardy A Plant To Be Uprooted By Article 9 of the U.C.C.?, 1971 U. Pitt. L.Rev. 580, 583.)

USF&G claims that the funds in Bak's DIP account for the Estelline project are no different than any other unpaid contract balance and that it is entitled to those funds pursuant to its right of subrogation, relying on *Pearlman*, *National Shawmut Bank* and other leading cases on equitable subrogation. First Fidelity asserts that the funds in Bak's DIP account for the Estelline project, already having been paid over by the city, rightfully belong to it as assignee because the payments had been made prior to any default by *Bak*. See *National Union Fire Ins. Co. of Pittsburgh v. United States*, 304 F.2d 465, Ct. Cl. (1962) and *American Fidelity Co. v. National City Bank of Evansville*, 266

F.2d 910 (D.C. Cir. 1959).

The presence of the segregated DIP account in the case at bar distinguishes it from Pearlman, National Shawmut Bank, National Union Fire and American Fidelity, and it is also determinative of the issue. There were no segregated DIP accounts in National Union Fire or American Fidelity and the courts in those cases decided that progress payments paid over to an assignee bank prior to default were not subject to subrogation by the surety of a defaulting contractor/assignor. Such accounts also did not exist in Pearlman or National Shawmut Bank, wherein it was held that the surety of a defaulting contractor is entitled to the unpaid contract funds and retainage held by the contract holder. However, the underlying analysis in the latter two cases and the spirit and logic of equitable subrogation, coupled with the restrictions placed upon the funds in the segregated DIP account (i.e., that they come from and be used only for the Estelline project) lead this Court to conclude that the funds in that account are properly payable to USF&G. Bak rejected the Estelline project and USF&G as surety fulfilled its responsibility to complete the project. As the funds in the segregated DIP account were to be used only for the Estelline project, the Court holds that USF&G is entitled to such funds remaining in that account.

II.

WHETHER USF&G, AS SURETY, OR FIRST FIDELITY, PURSUANT TO ITS BLANKET SECURITY INTEREST, IS ENTITLED TO CERTAIN MATERIAL FURNISHED FOR THE ESTELLINE PROJECT AND ABANDONED AT THE PROJECT SITE.

The second issue presented is whether USF&G or First Fidelity has a superior interest in a generator and pipe left by Bak at the construction site. According to the deposition testimony of Elsie Bak, the generator was incorporated into the project as a backup source of power to operate the pumps for the treatment of waste water. The generator was purchased from a supplier on September 10, 1986, with Bak making a \$14,000.00 down payment on the unit and leaving a balance of \$1,870.00 still to be paid to the supplier. The generator was later incorporated into the project by Prunty Construction. The pipe left by Bak at the construction site was likewise incorporated into the Estelline project. A letter from Bob Bak, which was intended to supplement Elsie Bak's deposition and to which the parties stipulated, stated that the pipe was acquired in November of 1984 and paid for in January of 1985.

First Fidelity argues that it has a superior interest in the generator and pipe pursuant to its claimed blanket security interest in Bak's inventory and equipment dating back to 1972. USF&G contends that it is entitled to these materials pursuant to the express terms of the agreement between the City of Estelline

Re: Robert & Elsie Bak
February 2, 1990
Page 8

and Bak. According to the agreement, the "Owner may . . . incorporate in the work all materials and equipment stored at the site or for which owner has paid the contractor but are stored elsewhere" if the contractor files a petition in bankruptcy. Subrogating its position to that of the city, USF&G claims that it is the owner of the generator and pipe.

The Court disagrees with USF&G's contention. Under the terms of the contract, the city could incorporate any material left by Bak at the construction site into the project. However, the Court does not equate the city's right to use the materials with the forfeiture of those materials by Bak, as USF&G appears to claim. Under the unambiguous terms of the contract and the doctrine of subrogation, USF&G could incorporate the materials left at the job site into the project. However, the plain wording of the contract does not contemplate that Bak would forfeit the property left at the job site or that title to such property would automatically be wrested from Bak, thus obviating the need to pay for materials, and such an interpretation cannot be construed from the contract.

The Court will next address which party has a superior interest in the pipe left at the job site. It should first be noted that First Fidelity and USF&G, in their stipulation filed November 1, 1989, agreed that "1[s]ince 1972, First Fidelity held a valid, perfected security interest in all inventory, machinery, and equipment owned by Bak." A review of the relevant financing statement, originally filed on October 3, 1972 and continued to the present, reveals that First Fidelity holds an interest in "[a]ll machinery, equipment, attachments, accessions, replacement parts, and tools now owned or hereafter acquired, used or bought for use, and used primarily in business, including but not limited to the construction business." The financing statement does not show that First Fidelity holds an interest in Bak's inventory, which under U.C.C. § 9-109(4)⁴ would include the pipe in question. There is an apparent conflict between what was stipulated to by the parties and the actual state of First Fidelity's filing. However, as the stipulation was voluntarily entered into by the parties, each of whom had access to the financing statement on file with the South Dakota Secretary of State, the Court believes that such stipulation should bind both First Fidelity and USF&G. The Court's position that stipulations of fact that are fairly entered into should be controlling on the parties is not without legal support. See *Fenix v. Finch*, 436 F.2d 831, 836 (8th Cir. 1971), *Furniture Forwarders of St. Louis v. Chicago, R.I. & P.R.R.*, 393 F.2d 537, 539 (8th Cir. 1968), *Osborne v. United States*, 351 F.2d 111, 120 (8th

⁴ U.C.C. § 9-109(4) defines inventory as "(a) Goods held for sale or lease or furnished under contracts of service, and (b) raw materials, work in process or materials used or consumed in a business.

Re: Robert & Elsie Bak
February 2, 1990
Page 9

Cir. 1965), and *Burstein v. United States*, 232 F.2d 19, 22 (8th Cir. 1956). The general rule is that parties are bound by stipulations voluntarily made and that relief from such stipulations. after judgment is warranted only under exceptional circumstances. *Farmers Co-op Elevator Ass'n. Non-stock, Big Springs, Neb. v. Strand*, 382 F.2d 224, 231 (8th Cir. 1967), cert. denied 389 U.S. 1014, 88 5. Ct. 589, 19 L. Ed. 2d 659 (1967); and *Ehlers v. Vinal*, 382 F.2d 58 (8th Cir. 1967). While relief may be granted from a stipulation under appropriate circumstances¹ no showing warranting such relief has been made here. See *O'Neill v. United States*, 411 F.2d 139 (3rd Cir. 1969) and *Osborne, supra*.

Operating from the premise that the bank's perfected security interest predated the effectuation of USF&G's master surety agreement, the Court believes that First Fidelity, under the holding in *Brunken, supra*, is entitled to the pipe. As set forth Earlier, *Brunken* stands for the proposition that an unsecured surety who is called upon to perform under the terms of its bond does not acquire a priority interest in the defaulting contractor's personal property as against a secured creditor whose interest has been perfected in compliance with the Uniform Commercial Code. *Id.* at 293-294. Here, First Fidelity's interest was perfected on October 3, 1972 and remains perfected through its timely filing of continuation statements. The earliest date to which USF&G can point in support of its position is June 12, 1981, the date on which it entered into the master surety agreement with Bak. First Fidelity's interest thus predates USF&G's by eight and one-half years. Under *Brunken*, First Fidelity is entitled to the pipe left by Bak at the construction site and later incorporated into the Estelline project by Prunty Construction.

The Court must next determine which party has a superior interest in the generator left by Bak at the construction site. As previously stated, the generator was purchased on September 10, 1986. Again, First Fidelity claims it has a superior interest in the generator by virtue of its perfected security interest in Bak's inventory. USF&G claims to have priority in the generator by subrogating itself to the rights of the City of Estelline under the contract between the city and Bak.

The Court has already rejected USF&G's argument contending that the materials left at the site became the property of the city, and thus that of the surety by virtue of subrogation, under the City of Estelline/Bak contract. At most, the contract authorized the city to incorporate those materials into the project. However, it appears that USF&G may nevertheless be entitled to the generator by virtue of Judge Ecker's July 22, 1986 order for cash collateral that required the establishment of a separate debtor in possession account for the Estelline project. The generator was purchased on September 10, 1986, almost two months after the cash collateral order was entered. Elsie Bak's

deposition testimony revealed that the funds to purchase the generator came from a progress payment made to Bak by the City of Estelline and that such payment was received by Bak in early September. The funds used to purchase the generator thus would have been subject to the cash collateral order.

The factual setting of this transaction leads the Court to conclude that USF&G is entitled to the generator. The funds used to purchase the generator came from the segregated DIP account and thus could only be used for the Estelline project. Having earlier found that USF&G is entitled to the balance of funds remaining in the DIP account for the Estelline project, and taking that determination to its logical conclusion, the Court likewise believes that USF&G is entitled to those materials that were purchased with such funds. This would be analogous to a determination of who would be entitled to the non-cash proceeds of the segregated DIP account under U.C.C. § 9-306. Having determined that the funds in the segregated DIP account belong to USF&G, those proceeds that can be traced back to the account (i.e, the generator) would likewise belong to USF&G.

In summary, the Court holds that United States Fidelity & Guaranty Company, as surety, is entitled to the funds remaining in the debtor in possession account for the City of Estelline project, which account is maintained at the First Fidelity Bank in Murdo. USF&G is likewise entitled to the generator that was incorporated into the Estelline project and that was purchased with funds from the aforementioned DIP account. The Court further holds that First Fidelity Bank of Murdo is entitled to the pipe that was left by Bak at the construction site and later incorporated into the Estelline project by virtue of its stipulated security interest in Bak's inventory. The Court will enter an appropriate order.

Very truly yours,

Irvin N. Hoyt
Chief Bankruptcy Judge

INH/sh
CC: Bankruptcy Clerk

UNITED STATES BANKRUPTCY COURT
DISTRICT OF SOUTH DAKOTA

IN RE:)	CASE NO. 386-00049
)	
ROBERT ALLEN BAK and)	ADVERSARY NO. 88-3003
ELSIE JEAN BAK, d/b/a/)	
BAK CONSTRUCTION COMPANY,)	
)	CHAPTER 11
Debtors,)	
)	

FIRST FIDELITY BANK OF MURDO,)	
)	
Plaintiff,)	
)	
vs.)	
)	
UNITED STATES FIDELITY &)	ORDER DETERMINING VALIDITY,
GUARANTY; ROBERT BAK; ELSIE)	PRIORITY AND EXTENT OF LIENS
BAK; THE CITY OF ESTELLINE,)	CLAIMED BY FIRST FIDELITY
SOUTH DAKOTA; THE ESTELLINE)	BANK OF MURDO AND UNITED
WASTE WATER TREATMENT PROGRAM,)	STATES FIDELITY AND
)	GUARANTY COMPANY
Defendants.)	

Pursuant to the memorandum executed this same date decision filed in this matter and

IT IS ORDERED, ADJUDGED AND DECREED that United States Fidelity and Guaranty Company is entitled to the balance of funds remaining in debtor Robert Allen Bak and Elsie Jean Bak, d/b/a/ Bob Bak Construction Company's segregated debtor in possession account for the City of Estelline waste water treatment project (EPA Project C460393-03), which account is maintained at the First Fidelity Bank in Murdo, South Dakota.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that United States Fidelity and Guaranty Company is entitled to a certain standby generator purchased by the debtors with funds from the segregated debtor in possession account for the Estelline project, which generator has been incorporated into said project.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that First Fidelity Bank of Murdo, South Dakota, by virtue of its stipulated security interest in the debtors' inventory, is entitled to certain pipe that was abandoned by the debtors at the construction site for the Estelline project, which pipe was later incorporated therein.

Dated this 2nd day of February, 1990.

BY THE COURT:

Irvin N. Hoyt
Chief Bankruptcy Judge

ATTEST:

PATRICIA MERRITT, CLERK

By _____
Deputy Clerk

(SEAL)