

07-2393-bk

United States Court of Appeals for the Second Circuit

In re: SUPREMA SPECIALTIES, INC.,

Debtors.

HARLEYSVILLE WORCESTER MUTUAL INSURANCE COMPANY,
LUMBERMENS MUTUAL CASUALTY INSURANCE COMPANY,
Plaintiffs-Appellants,

v.

BANK OF AMERICA, N.A., as successor by merger to FLEET
NATIONAL BANK, as agent for the SENIOR SECURED LENDER
GROUP, SUPREMA SPECIALTIES WEST, INC., SUPREMA
SPECIALTIES NORTHEAST, INC., SUPREMA SPECIALTIES
NORTHWEST, INC., SUPREMA SPECIALTIES, INC.,
Defendants-Appellees,

KENNETH P. SILVERMAN,

Trustee.

On Appeal from the United States District Court
for the Southern District of New York

**BRIEF FOR DEFENDANTS-APPELLEES
BANK OF AMERICA, N.A. AND THE
SENIOR SECURED LENDER GROUP**

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 26.1(a) of the Federal Rules of Appellate Procedure, Defendant-Appellee Bank of America, N.A. discloses that it is successor by merger to Fleet National Bank. Bank of America, N.A. is a wholly-owned subsidiary of NB Holdings Corporation. NB Holdings Corporation is a wholly-owned subsidiary of Bank of America Corporation, a publicly traded company. Based on information and belief, there are no publicly held corporations that own 10% or more of Bank of America, N.A.'s stock.

The Senior Secured Lender Group is a consortium of financial institutions that includes Fleet National Bank; Citibank, N.A.; First Pioneer Farm Credit, ACA; PNC Bank, National Association; GE Capital CFE Inc.; General Electric Capital Corp.; Sovereign Bank and United Trust Bank.

Defendant-Appellee Citibank, N.A. discloses that it is a wholly-owned subsidiary of Citigroup, Inc., a publicly traded company. Based on information and belief, there are no other publicly held corporations that own 10% or more of Citibank, N.A.'s stock.

Defendant-Appellee First Pioneer Farm Credit, ACA discloses that it has no parent corporations and that there is no publicly held corporation that owns 10% or more of First Pioneer Farm Credit, ACA's stock.

Defendant-Appellee United Trust Bank discloses that it was acquired by PNC Bank, National Association. PNC Bank, National Association is a wholly-owned subsidiary of PNC Financial Services Group, Inc., a publicly traded corporation.

Defendant-Appellee PNC Bank, National Association discloses that it is a wholly-owned subsidiary of PNC Financial Services Group, Inc., a publicly traded corporation. Based on information and belief, there are no publicly traded corporations that own 10% or more of PNC Bank, National Association's stock.

Defendants-Appellees GE Capital CFE Inc. ("GECFE") and General Electric Capital Corporation ("GE Capital") disclose that GECFE is a wholly-owned subsidiary of GE Capital and that GE Capital is a wholly-owned subsidiary of General Electric Capital Services, Inc. General Electric Capital Services, Inc. is a wholly-owned subsidiary of General Electric Company, a publicly traded corporation. Based on informa-

tion and belief, there are no publicly traded corporations that own 10% or more of GECFE or GE Capital's stock.

Defendant-Appellee Sovereign Bank discloses that it is a wholly-owned subsidiary of Sovereign Bancorp, Inc., a publicly traded corporation. Banco Santander Central Hispano, S.A. is a publicly traded corporation and owns approximately 25% of Sovereign Bancorp, Inc. Based on information and belief, there are no other publicly held corporations that own 10% or more of Sovereign Bank's stock.

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JURISDICTIONAL STATEMENT

Appellants' jurisdictional statement is correct except that this Court's jurisdiction is based not only on 28 U.S.C. § 158(d) but also on 28 U.S.C. § 1291.

ISSUE PRESENTED

Whether the bankruptcy court and the district court were both correct in holding that, under the doctrine of equitable subrogation, a surety that does not agree to step into the shoes of the principal obligor and complete performance of an ongoing project, and that is not seeking a retainage fund retained by a project owner, is subrogated only to the rights of the creditor (obligee) to which the surety was required to make payment when the principal obligor failed to make such payment.

STANDARD OF REVIEW

“[A] district court order issued in its appellate capacity is subject to plenary review.” *Aetna Cas. & Sur. Co. v. Clerk, U.S. Bankruptcy Court, New York (In re Chateaugay Corp.)*, 89 F. 3d 942, 946 (2d Cir. 1996). This Court reviews “the factual findings made by the bankruptcy

court under the clearly erroneous standard and its legal conclusions *de novo*.” *Id.* Here, there are no factual disputes between the parties. *See* SPA-13¹; SPA-48; Appellants’ Br., at 28.

STATEMENT OF THE CASE

This adversary proceeding arises in the context of a bankruptcy case occasioned by massive fraud perpetrated by certain members of the debtors’ former senior management team. Not only did the fraud result in the debtors’ bankruptcy, but it also led to investigations by various federal and state agencies culminating in civil lawsuits brought by the government and by the debtors’ shareholders, as well as the criminal prosecution of several members of the debtors’ senior management team.

Among the many victims of this fraud are the two main parties to this proceeding: Two creditors of the debtors that each suffered millions of dollars in financial losses that they will never recover in full from the bankruptcy estate. At issue in this dispute is whether certain payments received by the debtors shortly before and after their filing for bank-

¹ The opinions of the bankruptcy court and district court are reproduced in the Special Appendix attached to Appellants’ Opening Brief and are denoted herein as “SPA-__.” Portions of the Record on Appeal are reproduced in the Joint Appendix, denoted herein as “A-__.”

ruptcy were properly distributed to Appellees, a group of banks to whom the debtors owed almost \$100 million, who had a prior perfected lien over all of the debtors' assets.

In the proceedings below, Appellants, sureties who were required to pay a \$4 million debt of the debtor to a third party, claimed a right to these funds under numerous theories, including the doctrine of equitable subrogation. Both the bankruptcy court and the district court rejected the sureties' claims under each of their theories and held that the proceeds of these payments are the property of the banks.

The sureties now appeal the lower courts' holdings only with respect to a limited portion of their equitable subrogation claim. Specifically, they argue that the lower courts erred in failing to recognize a pre-petition lien over these payments, which the sureties claim to have acquired by subrogation to the *debtors'* rights (as opposed to the rights of the debtors' creditors into whose shoes the sureties have stepped). As we discuss below, the courts were plainly correct in holding that the sureties possessed no such lien because they were not entitled to subrogate to the debtors' rights, and in any event any rights the sureties ob-

tained via subrogation arose after the debtors filed for bankruptcy and are inferior to the banks' perfected security interest in those assets.

A. The parties to this proceeding.

The debtors in this case, Suprema Specialties, Inc., Suprema Specialties West, Inc., Suprema Specialties Northeast, Inc., and Suprema Specialties Northwest, Inc. (collectively, "Suprema"), were manufacturers, marketers and distributors of gourmet Italian cheeses, and were licensed by the New York Commissioner of Agriculture and Markets ("Commissioner") as milk dealers. Suprema filed voluntary petitions for relief under Chapter 11 on February 24, 2002. These cases subsequently were converted to cases under Chapter 7, and Kenneth P. Silverman, Esq. was appointed the Chapter 7 Trustee ("Trustee").

Appellee Fleet National Bank (subsequently succeeded, through merger, by Bank of America, N.A., and referred to as the "Agent"), is a member of and agent for a consortium of financial institutions that include Citibank, N.A.; First Pioneer Farm Credit, ACA; PNC Bank, National Association; GE Capital CFE Inc.; General Electric Capital Corp.; Sovereign Bank and United Trust Bank (collectively "Appellees," the "Senior Secured Lender Group" or the "Bank Group"). The Agent, on

behalf of the Bank Group, is a secured lender holding priority, perfected, liens on Suprema's assets, including accounts receivable. At the time Suprema filed its petition for bankruptcy protection, on February 24, 2002, Suprema was indebted to the Bank Group in the principal amount of approximately \$97,565,838, plus interest and fees.

Appellants, Harleysville Worcester Mutual Insurance Company and Lumbermens Mutual Casualty Insurance Company (collectively "the Sureties"), are two surety companies that executed a bond on behalf of Suprema for the payment of Suprema's obligations to milk suppliers. Months after Suprema's Chapter 11 bankruptcy filing and subsequent conversion to Chapter 7, the Sureties were called upon to pay \$3,882,571.19 under the bond. They assert that they are entitled to recover a portion of this amount, \$2,362,697.11, from the payments Suprema received from its milk and cheese sales—despite the Bank Group's first priority lien on all of Suprema's assets.

B. The Bank Group's perfected security interests in Suprema's assets.

On September 23, 1999, the Bank Group entered into a Third Amended and Restated Revolving Loan, Guaranty and Security Agreement ("Loan Agreement") with Suprema, as Borrower, and other guar-

antors. *See* SPA-4–5. Under the Loan Agreement, Suprema could borrow up to \$140,000,000 from the Bank Group. *See* SPA-5. To obtain loans under the Loan Agreement, Suprema had to submit a “Borrowing Base Certificate” certified by its chief financial officer each calendar month demonstrating that Suprema maintained an appropriate ratio of loans outstanding to Eligible Receivables and Eligible Inventory, as defined in the Agreement. *See id.* As is standard in the asset-based financing arena, the Loan Agreement required Suprema to maintain its operating accounts with the Agent. *See id.* The Agreement also granted the Agent, on behalf of the Bank Group, a right to set off obligations due to it under the Agreement against Suprema’s deposits held by the Agent or any other member of the Bank Group. *See id.* Finally, the Agreement provided that the line of credit extended to Suprema was secured by a first-priority lien and security interest on all of Suprema’s assets, property and proceeds thereof, including accounts receivable, inventory, contract rights, and deposits. *See id.* It is undisputed that the Agent perfected the Bank Group’s security interests by filing the financing statements as required under the Uniform Commercial Code (“UCC”). *See id.*; A-391.

C. The Sureties' relationship to Suprema.

To obtain a license as a milk dealer in New York State, Suprema was required to provide the Commissioner with a bond or other security guaranteeing the prompt payment of its obligations to milk suppliers. *See* N.Y. AGRIC. & MKTS. LAW § 258-b. The statute also establishes procedures for a milk supplier to recover payment from the Commissioner in the event of a payment default by a milk purchaser. Under the statute, the milk supplier must first file a claim with the Commissioner, which prompts an audit and investigation of the claim. After completion of the audit and a determination and certification of the amount due, the Commissioner will then make a demand to the surety that provided the bond as a guarantee for payment. *See id.* §§ 258-b(5)(c)–(d); (b)(9).

On October 15, 2001, almost two years after the Bank Group perfected its security interest in Suprema's assets, the Sureties issued such a bond in the penal amount of \$5,100,000 to Suprema Northeast, Inc., as principal, naming the Commissioner as the beneficiary or obligee (the "Bond"). *See* SPA-5–6; A-149. By its terms, the Bond was in effect between July 1, 2001 and June 30, 2002. A-149. The Sureties' obligations under the Bond are voided if Suprema makes payments due to

milk producers, or to the Commissioner or another duly appointed agent, for milk received from New York producers during this period; otherwise it remains in effect. A-149. The Bond also requires that any claim under it for milk received and not paid for by the principal must be filed with the Commissioner within two years from the date of expiration of the Bond. A-150.²

Suprema also executed a “General Agreement of Indemnity” in favor of Harleysville and a “Commercial General Indemnity Agreement” in favor of Lumbermens to protect the Sureties in the event the Sureties were required to make payment under the Bond. *See* SPA-6. By their terms each indemnity agreement inures to the benefit of both sureties. A-39; A-50.

² The Sureties’ contention that their obligations to make payment under the Bond is triggered “merely by a payment default by Suprema,” Appellants’ Br. at 13 n.5, is supported neither by the terms of the Bond nor by N.Y. AGRIC. & MKTS. LAW § 258-b. The fact that the Sureties’ obligations remain in effect so long as Suprema has not made payment for the milk, *see* A-149, does not mean that the Sureties’ obligation was ***triggered*** by Suprema’s default. As the Bond states, the Sureties would have no obligation to make payment if Allied failed to file a claim within two years from the expiration date of the Bond. A-150. Moreover, under N.Y. AGRIC. & MKTS. LAW § 258-b(5)(c)–(d) & (b)(9), the Sureties have no obligation to make payment under the Bond until after Allied files a claim with the Commissioner, the Commissioner investigates and certifies the claim, and the Commissioner seeks payment from the Sureties.

The Harleysville General Agreement of Indemnity (hereinafter referred to as the “Indemnity Agreement”) seeks to create collateral security for the benefit and payment of all obligations for which the Sureties may be liable under the Bond. Section 2 of the Agreement provides that, upon the Sureties’ demand to establish a reserve deposit, Suprema would be required to deposit with the Sureties a sum of money equal to such reserve as collateral security. *See* SPA-6. It is undisputed that the Sureties made no demand for a reserve deposit and that Suprema did not deposit funds with the Sureties. *See* SPA-7; A-396 ¶¶9–10. Section 4 of the Agreement authorizes the Sureties to require Suprema to create a formal trust account, through which payments Suprema received from its milk and cheese sales would be held for the Sureties’ benefit, but it is undisputed that neither the Sureties nor Suprema ever took the necessary steps to establish such a trust account. *See* SPA-23–25; SPA-58–60.³

³ As the bankruptcy court and the district court found—and the Sureties no longer dispute—neither the parties’ actions nor the Indemnity Agreement itself impressed a trust upon these payments or created any collateral security for the benefit and payment of all obligations for which the Sureties may be liable under the Bond. *See* SPA-21–26; SPA-55–60.

At the time the Sureties posted the Bond and entered into the Indemnity Agreements the Sureties knew that the Bank Group had a perfected security interest in all of Suprema's assets. *See* SPA-6; A-397 ¶16. At no time, however, did the Sureties ever file UCC financing statements to perfect their interests under the Indemnity Agreement. *See* SPA-7; A-397 ¶15.

D. Events leading to Suprema's bankruptcy petition.

On December 21, 2001, Suprema issued a press release disclosing the sudden resignations of its chief financial officer and comptroller. *See* SPA-7–8. On the same day, the Securities and Exchange Commission commenced an investigation and NASDAQ suspended trading in Suprema's stock. *See* SPA-8. By the end of January 2002, the Federal Bureau of Investigation, the Food and Drug Administration, the New Jersey Department of Health, and the New Jersey Department of Agriculture had started their own investigations of Suprema. *See id.* These investigations ultimately revealed that Suprema's reported growth in the past was an illusion produced in large part by a fraudulent scheme carried out by some of its officers involving, among other things, "round-trip" sales, or circular transactions, associated with the hard cheese

part of Suprema's business. *See generally In re Suprema Specialties, Inc. Securities Litig.*, 2006 WL 408205 (3d Cir. Feb. 23, 2006); SPA-8.

Indeed, the fraud was in large part directed at the Bank Group. The Borrowing Base Certificate for the month ending December 31, 2001, delivered to the Bank Group on January 23, 2002, indicated that Suprema had an outstanding debt of \$94,942,557 to the Bank Group and that it was eligible to borrow an additional \$13,342,938. *See* A-917–22. The Bank Group subsequently discovered that certain items listed as Eligible Receivables or Eligible Inventory on the Borrowing Base Certificates previously delivered by Suprema were fictitious and that the collateral securing the loans made under the Loan Agreement was worth significantly less than Suprema had represented to the Bank Group. *See* SPA-8.

On January 30, 2002, the Agent, on behalf of the Bank Group, sent Suprema a reservation of rights letter advising Suprema that it was in breach of the Loan Agreement and that the Bank Group had decided to discontinue extending credit to Suprema, as permitted under the Loan Agreement. *See* SPA-8–9. In early February 2002, the Bank Group commenced a review of Suprema to determine the extent of the

Bank Group's exposure on Suprema's outstanding indebtedness to the lenders. *See* SPA-9. As authorized by the Loan Agreement, the Bank Group received confidential information relating to Suprema's operations and financial condition. *See id.*

The Bank Group and Suprema subsequently engaged in discussions to ascertain whether, given the challenges facing the company, any aspect of Suprema's businesses could be salvaged and whether such business could support the Bank Group's large exposure. *See* SPA-9. On or about February 4, 2002, Suprema, as is common in such distressed situations, retained an independent crisis-management firm, which Suprema gave the responsibility to review and attempt to stabilize its business operations. *See id.* The retention agreement expressly permitted the crisis manager to share information about Suprema with the Bank Group, and instructed the crisis manager to limit disbursements to those that were absolutely necessary. *See id.* Ultimately, the crisis manager failed to obtain control over Suprema's cash flow. *See* A-923, A-930–31.

Suprema terminated the engagement of the crisis manager on February 19, 2002, and its board hired another crisis-management firm

the next day. *See* SPA-10. A few days later, the new crisis manager determined that a bankruptcy filing would be the best means to gain control over Suprema's cash flow and to reorganize any business units that could potentially continue. *See* A-730–35. In anticipation of the filing, the crisis manager advised Suprema to cease all payments to creditors, except for legal fees (to ensure assistance with the bankruptcy filing) and payroll expenses until Suprema could secure a debtor-in-possession financing order. *See id.*

On February 19, 2002, the Agent, on behalf of the Bank Group, advised Suprema of a number of additional defaults under the Loan Agreement and of the Bank Group's decision to exercise its right under the Loan Agreement to set off all deposits in Suprema's accounts (but not including trust funds) maintained with the Agent. *See* SPA-11. The Bank Group subsequently took possession of funds in these accounts. *See id.*

Thereafter, on February 24, 2002, Suprema filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 101 *et seq.*, in the United States Bankruptcy Court for the Southern District of New York. *See* SPA-11. On the petition date, Suprema was indebted

to the Bank Group in the principal amount of approximately \$97,565,838, plus interest and fees. *See id.*

E. The payments at issue in this proceeding.

Allied Federal Cooperatives, Inc. (“Allied”), a milk producer, sold milk to Suprema under a Milk Supply Agreement dated July 1, 1996 (“Allied Contract”). *See* A-655–71. In addition to obligating Suprema to purchase a minimum volume each month, the Allied Contract provides that payments for the milk would be prescribed by the Federal Milk Marketing Order No. Two, 7 C.F.R. 1002.1 *et seq.*, which requires that payments be made on the last day of the month with respect to all deliveries made through the 15th day of the month of delivery, with the balance to be paid on the 15th day of the following month for all milk purchased from the sixteenth of the month through the end of said delivery month. *See* A-657–59.⁴ Under the terms of the Allied Contract, upon delivery of milk to Suprema or to another location as directed by Suprema, “title thereto shall be deemed to have passed from SELLER

⁴ Federal Milk Marketing Order No. Two was replaced by Part 1001—Milk In The Northeast Marketing Area, 7 C.F.R. Part 1001 (the so-called “Northeast Federal Order”), which requires a milk dealer to pay its supplier on or before the 26th day of any month for milk received during the first 15 days of the month and by the 16th of the following month for the balance owed for any month. *See* 7 C.F.R. § 1001.73.

to PURCHASER free and clear of all liens.” A-658–59. In the event of a party’s breach or failure to perform, the Allied Contract provides that the non-defaulting party’s sole remedy (besides for an action to collect the money due) is to terminate the agreement upon written notice. *See* A-663.⁵

Although Suprema historically used much of the milk it purchased from Allied to produce “soft cheeses,” such as mozzarella, it also resold excess milk to others, because its contract with Allied required Suprema to purchase at least a specified quantity of milk each month, regardless of its needs. *See* A-657–58. Suprema re-sold this excess milk through Dairy Market Services, LLC (“DMS”), a partnership between Dairy Farmers of America and Dairy Lea Cooperative (“Dairy Lea”), pursuant to a Milk Supply Agreement between Suprema and DMS, dated December 1, 2000 (“DMS Contract”). *See* A-192–99. Under the terms of the DMS Contract, Suprema was to deliver the milk purchased by DMS to Kraft; upon delivery title to the milk sold by Suprema transferred to DMS. *See* A-192–93. The milk purchaser’s obligation to pay for milk

⁵ Subsequent amendments to the Allied Contract did not change any of the terms relevant to this proceeding. *See* A-672–79. Under the most recent amendment, dated August 23, 2000, the Allied Contract governed milk sales between August 1, 2000, and July 31, 2017. *See* A-675.

arose when the milk was delivered to Kraft's facilities. *See id.* In other words, the DMS Contract conditions Suprema's rights to receive payment from a milk purchaser solely upon delivery of the milk to Kraft's facilities.

During the 40-day period before its bankruptcy filing, Suprema continued to purchase milk from Allied under the Allied Contract. *See* SPA-10. Between January 15, 2002, and February 23, 2002, Suprema purchased \$3,888,571.19 worth of milk from Allied, and resold a portion of this milk to DMS under the DMS Contract. *See id.* at 10–11. Under Suprema's direction, Allied delivered approximately \$2,123,793 worth of milk purchased by Suprema during this period directly to Kraft. *See id.* at 10. Suprema made a payment of \$1,442,835.87 to Allied on January 28, 2002 for the milk received on or before January 15, 2002. *See id.* at 10–11. On February 19, 2002, Allied demanded payment from Suprema in the amount of \$1,700,000 for milk Allied delivered to Kraft between January 15, 2002, and January 31, 2002, but Suprema did not respond to this demand for payment or to subsequent demands for payment. *See id.* at 11.

On February 19, 2002, Suprema received a wire transfer of \$907,402.67 into its operating account from Dairy Lea for milk delivered to Kraft between January 15, 2002, and January 31, 2002. *See* A-402 ¶37. In the months following Suprema's bankruptcy filing, Kraft and Dairy Lea remitted three additional payments, totaling \$1,455,294.77, to Suprema's debtor-in-possession account or the Trustee's account for milk delivered between February 1 and February 23, 2002. *See id.*; A-230–48. The Sureties claim to have identified approximately \$2,362,297 in payments made by Kraft and Dairy Lea to Suprema for milk sold under the DMS contract that Allied delivered to Kraft. *See* SPA-11.⁶

On May 3, 2002, the Commissioner made a claim under the Bond for payment of \$3,882,571.19 based on Suprema's failure to pay Allied for milk purchased between January 15, 2002, and February 23, 2002. *See* SPA-12. According to the Commissioner's determination, the milk sold to Suprema was subject to the Northeast Federal Order and thus

⁶ We note that simple arithmetic suggests that this figure should be \$2,362,697; we do not know how the Sureties arrived at \$2,362,297. *See* SPA-42 & n.15. The post-petition payments Suprema received for the brokered milk under the DMS Contract were included in the approximately \$12.6 million distributed to the Bank Group by the bankruptcy court between Suprema's bankruptcy filing and December 2002.

“Suprema was required to pay Allied by January 26, 2002 for milk received January 1–15, 2002; by February 16, 2002 for milk received January 16–31, 2002 and any balance owing for milk purchased January 1–15, 2002; by February 26, 2002 for milk received February 1–15, 2002; and by March 16, 2002 for milk received February 16–24, 2002 and any balance owing for milk purchased February 1–15, 2002.” *Id.* at 10. On June 5, 2002—more than three months after Suprema filed for bankruptcy—the Sureties paid the Commissioner. *See id.* at 12.

In the proceedings below, the Sureties sought to recover the full amount they paid on the bond, \$3,882,571.19—the amount Suprema owed Allied for the milk it purchased under the Allied Contract—from Suprema’s bankruptcy estate and/or from the Bank Group. *See* A-29–30 ¶1–3; SPA-43. According to the Sureties, this amount, which the Sureties refer to as the so-called “Bonded Transaction Assets,” A-7 ¶5, should have been paid to it from the payments Suprema earned from the sale of the cheese it produced using that milk and from its resale of the milk under the DMS Contract. On appeal, the Sureties have narrowed their claim and now contend only that they are entitled to the

payments Suprema received under the DMS Contract, that is \$2,362,697. *See* Appellants' Br., at 9, 50.

F. The proceedings below.

1. Bankruptcy court.

On February 24, 2002, Suprema filed a petition for reorganization under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York, and was allowed at that time to continue operations as a debtor in possession. *See* SPA-11. On March 20, 2002, the bankruptcy court converted Suprema's cases to a Chapter 7 liquidation and thereafter appointed Kenneth P. Silverman, Esq. as Chapter 7 Trustee. *See* SPA-11–12.

The Sureties commenced this adversary proceeding on May 6, 2002, challenging the priority of the Bank Group's liens and security interests. *See* SPA-12. In their Third Amended Complaint ("Complaint"), filed on April 25, 2003, the Sureties asserted four claims. The first claim, which is irrelevant to this appeal, is that Suprema breached its contractual obligations to indemnify the Sureties. *See* A-24–25, ¶¶118–21. Under the Sureties' three remaining claims they sought to recover the amount paid out pursuant to the Bond from the Bank Group—the so-called Bonded Transaction Assets. According to the Sureties' Com-

plaint, their entitlement to this amount from Suprema's estate is superior to any rights held by the Bank Group under four alternative theories: (i) equitable subrogation arising out of Suprema's default in paying Allied, which ripened into the Sureties' post-petition payment to the Commissioner under the Bond; (ii) an express trust on the Bonded Transaction Assets in favor of the Sureties in accordance with the Indemnity Agreements; (iii) similarly, an assignment of this amount to the Sureties under those Agreements; and (iv) pursuant to the doctrine of equitable subordination. *See* A-25–29, ¶¶122–48. The Sureties contended that under each of these theories an amount equal to the Bonded Transaction Assets was set aside from Suprema's property for the Sureties' exclusive benefit and never became part of Suprema's bankruptcy estate. Thus, according to the Sureties, that amount of money is not subject to the Bank Group's priority liens. *See* A-29–31, ¶¶1–5. The Bank Group and the Trustee each answered the Third Amended Complaint on May 30, 2003, denying liability. *See* A-77–78, A-57–58.

On March 14, 2006, the Sureties filed a motion for summary judgment on all of their claims. *See* A-101–03. The Bank Group opposed the Sureties' motion and filed a cross-motion for summary judgment on

the Sureties' express trust and assignment, equitable subrogation, and equitable subordination claims. *See* A-421–22. The Trustee also opposed the Sureties' motion, joined the Bank Group's cross-motion and moved for a dismissal of the Complaint. *See* SPA-28. On April 28, 2006, the Sureties withdrew their claim for relief based on the doctrine of equitable subordination. SPA-13.⁷ On June 8, 2006, United States Bankruptcy Court Judge James M. Peck denied the plaintiffs' motion and granted

⁷ We note that in the Sureties' brief they discuss and attempt to castigate the Bank Group for its supposed involvement in directing the actions of Suprema in the weeks leading up to its bankruptcy filing. *See* Appellants' Br., at 18–22. But although these disputed facts and innuendoes might have some relevance to an equitable subordination claim, a claim that the Sureties voluntarily withdrew, they are entirely irrelevant to the legal claims at issue in this appeal. Yet the Sureties included many of these irrelevant facts in their brief, presumably in an attempt to portray the Bank Group in a negative light. By so doing they ultimately accomplish nothing but to introduce and then confuse elements of a claim that they chose to drop, without adding anything to the claims they are appealing here. In any event, the Sureties' description of these events is highly misleading. For example, the Sureties submit as fact that "it appears that a deliberate decision was made by the Bank Group not to allow payment of Allied's bill" because Suprema, against its crisis manager's recommendations, did not pay Allied; an inference that is reinforced by the Bank Group's sweep of Suprema's accounts. *Id.* at 21. But the Sureties do not dispute that the Bank Group had a right to set off Suprema's debts from funds in accounts maintained with the Agent, a right that the Bank Group exercised only after numerous defaults under the Loan Agreement. Moreover, the fact that *Suprema* disregarded its crisis manager's recommendations does not mean that the *Bank Group* had any part in Suprema's decision, and the Sureties have pointed to no evidence of any such involvement.

the defendants' motion for summary judgment on the Sureties' equitable subrogation, express trust and assignment claims. *See* SPA-25–26.

The bankruptcy court concluded that the Bonded Transaction Assets were part of Suprema's bankruptcy estate and that the Bank Group had a priority security interest in that amount. First, the court rejected the Sureties' equitable subrogation claim. Noting that "[e]quitable subrogation gives the surety that pays under its bond the right to recover amounts advanced on behalf of a principal by allowing the surety to substitute itself for the creditor whose claim has been satisfied," the court held that the Sureties' subrogation rights "give them no more than the rights that Allied would have had as an unsecured seller of milk—the rights to assert unsecured claims for Suprema's failure to pay and breach of contract." SPA-18. Judge Peck also found that the Sureties' equitable subrogation rights "were contingent or inchoate when the default occurred on February 16, 2002, and given the nature of the Sureties[] undertaking to the Commissioner, these rights could not be asserted until payment under the Bond." *Id.* at 17. Because the Sureties did not make payment under the Bond until months after Suprema's bankruptcy petition, at which point there were no identified as-

sets or proceeds outside of the bankruptcy estate, the court determined that their claim for subrogation gave them only “the right to receive a percentage distribution as members of the class of unsecured creditors” under Suprema’s bankruptcy plan. *Id.* at 19.

Judge Peck also rejected the Sureties’ express trust and assignment claims. The court held that the Indemnity Agreement did not demonstrate that the parties intended to establish a trust over the Bonded Transaction Assets because the Agreement did not meet two of the four required elements of an express trust. SPA-22. Moreover, the parties’ conduct was not consistent with a trust relationship because “the commingling of funds,” expressly permitted under the Indemnity Agreement, “effectively destroys any ability to separately identify the subject matter of the alleged trust at this point, and is consistent with a debtor-creditor relationship, not a trust.” SPA-25. The court denied the Sureties’ assignment claim because the Indemnity Agreement did not identify the funds allegedly assigned to the Sureties and the Sureties took no action, including the filing of UCC financing statements, to perfect their claim to these funds. *See* SPA 25–26. As a result, the court

concluded that “the unperfected assignment claim of the Sureties is insufficient to defeat the superior claim of the Bank Group.” SPA-26.

2. District court.

The Sureties appealed the bankruptcy court’s decision with respect to their equitable subrogation and express trust claims to the United States District Court for the Southern District of New York.⁸ Judge Shira A. Scheindlin affirmed the bankruptcy court’s judgment in its entirety.

In particular, Judge Scheindlin held that the Sureties did not acquire an equitable lien over the Bonded Transaction Assets under the doctrine of equitable subrogation. The court first noted that although the Sureties were plainly entitled to step into the shoes of *Allied*, the obligee, the Sureties’ subrogation to the rights of Allied “provides the Sureties, by definition, no greater rights than those possessed by Allied itself.” SPA-50. Because Allied possessed “only the right to assert an unsecured claim against Suprema based on Suprema’s failure to make payment for the milk it purchased,” the court held that the Sureties’ subrogation to Allied’s rights “provides the Sureties[] with the same un-

⁸ The Sureties abandoned their assignment claim at this point.

secured claim”—a claim that is subordinate to the Bank Group’s secured claims. SPA-50–51.⁹

Judge Scheindlin next held that the doctrine of subrogation did not permit the Sureties to step into the shoes of *Suprema*, the obligor. SPA-53. The court noted that, although in certain limited circumstances—most commonly found in the construction industry—a surety may be subrogated to the rights of the principal obligor, those circumstances were not present in this case. SPA-51. First, a surety in the construction context not only guarantees payment but also promises to step in and *perform* the contract in the event of a default by the principal obligor, including for example paying laborers and materialmen. *Id.* Second, the equitable subrogation doctrine only allows the subrogee to step into the shoes of the principal obligor if there is a retainage fund established by the project owner that serves as collateral security for the contract. SPA-52. The court explained that when a surety steps in to

⁹ Even though this was the Sureties’ primary argument to the district court, *see* Sureties’ D. Ct. Br., at 21–30; *cf. id.* at 34 (addressing the Sureties’ subrogation rights acquired through *Suprema* in only one paragraph), the Sureties do not take issue with this aspect of the district court’s holding on appeal. They have therefore waived the argument that they are entitled to recover by virtue of being equitably subrogated to the rights of Allied. *See Graves v. Finch Pruyn & Co.*, 457 F.3d 181, 184 (2d Cir. 2006).

perform a contract in the place of the principal obligor after that obligor's default, the surety is entitled to step into the shoes of the defaulting principal in order to receive the retained funds upon completion of the project, which but for the principal's default would have been paid to the principal as consideration for the contract's completion. *Id.* Here, by contrast, the Sureties "merely paid the debt that Suprema owed to Allied"; the Bond did not provide for any performance obligations and there was no retainage fund or similar segregation of funds held by Allied. SPA-51–53. Thus, the court explained, "[n]othing about this case merits extension of the doctrine of subrogation to permit the Sureties to step into the shoes of Suprema" to obtain an equitable lien over the Bonded Transaction Assets. *Id.*

In addition, Judge Scheindlin held that the Sureties' subrogation rights, whatever those rights might be, did not arise until *after* Suprema filed for bankruptcy. SPA-54. According to the district court, "the Sureties' obligation under the bond remained inchoate despite the default of Suprema." *Id.* Their obligation to pay did not become fixed until Allied made a demand to the Commissioner for payment, the Commissioner investigated Allied's claim, and the Commissioner filed his de-

termination and certification of the amount due. *Id.* Because the Commissioner did not file that determination until long after Suprema filed for bankruptcy, the Sureties did not incur any loss before the petition date and thus had no tangible claim at the time of Suprema's filing. *Id.* at 54–55. As a result, the court explained, “the Sureties’ subrogated unsecured claim to the Bonded Transaction Assets is not superior to the secured claims of the Bank Group.” *Id.*

Finally, the district court rejected the Sureties’ express trust claim on the grounds that the Indemnity Agreement failed to comply with two of the four required elements to create an express trust and that although the Agreement authorized the Sureties to demand that Suprema create a trust for the Sureties’ benefit, neither the Sureties nor Suprema ever took the necessary steps to establish such a trust account. SPA-55–60.¹⁰ The district court entered judgment on May 7, 2007. Appellants timely filed their Notice of Appeal on June 4, 2007.

¹⁰ The Sureties do not challenge the district court’s holding with respect to their express trust claim on appeal, and thus have forfeited the issue. *See Graves*, 457 F.3d at 184.

SUMMARY OF ARGUMENT

The central question in this appeal is whether the Bonded Transaction Assets—and in particular, the payments Suprema received from Dairy Lea and Kraft—are part of Suprema’s bankruptcy estate. The Sureties do not and could not dispute that, if that money belonged to Suprema at the time it filed for bankruptcy, those assets are part of the bankruptcy estate and were properly distributed to the Bank Group based on its secured priority interest. *See* Appellants’ Br., at 28. Nor do the Sureties challenge the lower courts’ holdings that the Bonded Transaction Assets are not collateral securing the Sureties’ obligations under the Bond, whether by assignment or through the imposition of an express trust. *See* SPA-25–26; SPA-27–31. Furthermore, the Sureties no longer even argue that they acquired a superior claim to these assets by subrogation to the rights of the *obligee*, Allied. They apparently now admit that the Sureties’ subrogation to Allied’s rights includes only the right to assert an unsecured claim against Suprema, which is subordinate to the Bank Group’s secured claim and does not operate to exclude those assets from Suprema’s bankruptcy estate. *See* SPA-18; SPA-50–51.

At this point, the Sureties' only remaining argument is that they acquired a pre-petition lien on the Bonded Transaction Assets by subrogation to the rights of Suprema, the primary obligor. The district court correctly rejected that argument. The Sureties are not subrogated to the rights of Suprema under the doctrine of subrogation, and thus do not possess a pre-petition lien over these assets.

I. The Sureties' argument that they subrogate to Suprema's rights fails because in situations in which a surety merely repays a debt owed by the principal obligor and there is no collateral securing that debt, the doctrine of subrogation permits the surety to subrogate only to the rights of the *obligee* of the bond, not also to the rights of the principal *obligor*. See *In re Chateaugay*, 89 F.3d at 947. Although under limited circumstances the doctrine of equitable subrogation allows a surety to subrogate to the rights of the principal obligor, and thus to acquire an equitable lien over retained funds to which the principal would have been entitled had it performed its obligations, those circumstances are not present in this case. Because this exception is inapplicable here, the Sureties subrogate only to Allied's rights, which do not entitle the Sure-

ties to an equitable lien over the Bonded Transaction Assets. *See* pages 32–48, *infra*; SPA-17–18; SPA-51–53.

II. Even if the Sureties were entitled to use the doctrine of equitable subrogation to step into the shoes of the principal obligor, Suprema, they nonetheless cannot acquire an equitable lien over the Bonded Transaction Assets—the proceeds from the eventual sale of the milk to DMS—because a surety can subrogate only to an equitable lien over property securing the ***underlying*** obligation—Suprema’s payment for the milk purchased from Allied. *See Pearlman v. Reliance Co.*, 371 U.S. 132, 141 (1962). It is undisputed that the Bonded Transaction Assets did not serve as security for Suprema’s obligations under the Allied Contract; thus the Sureties’ subrogation rights do not include an equitable lien over these Assets. *See* pages 48–57, *infra*.

III. Finally, even if the Sureties were entitled to use the doctrine of equitable subrogation to step into the shoes of the principal obligor, Suprema, the Sureties’ subrogation rights in this case did not arise until the Sureties made payment under the Bond, which was ***after*** Suprema had filed for bankruptcy. Having incurred no loss before Suprema filed its petition for bankruptcy, the Sureties had only a contin-

gent or inchoate claim at that time. Under these circumstances, the Sureties' subrogation rights could not have the effect of excluding the Bonded Transaction Assets from Suprema's bankruptcy estate. *See* pages 57–62, *infra*; SPA-17–18; 54–55. Thus, the Bank Group's perfected security interest in the Bonded Transaction Assets would still trump those subrogation rights, even if the Sureties could acquire via subrogation the rights of Suprema in addition to the rights of Allied.

Accordingly, this Court should affirm the lower courts' determination that the Bonded Transaction Assets are part of Suprema's bankruptcy estate, and thus were correctly distributed to the Bank Group.

ARGUMENT

According to the Sureties, the payments Suprema received from Dairy Lea and Kraft never became part of Suprema's bankruptcy estate because the Sureties obtained a pre-petition lien over these assets through subrogation to Suprema's rights. *See* Appellants' Br., at 25–27. As the bankruptcy court and the district court both held, this argument lacks merit. *See* SPA-18; SPA-25.

I. The Sureties Are Not Subrogated To The Rights Of Suprema.

As the district court held, “[n]othing about this case merits extension of the doctrine of subrogation to permit the Sureties to step into the shoes of Suprema.” SPA-53. Accordingly, the Sureties’ subrogation rights include only the rights held by Allied, which undisputedly consist of “only the right to assert an unsecured claim against Suprema based on Suprema’s failure to make payment for the milk it purchased.” SPA-50–51; *see* SPA-18.

A. Under most circumstances sureties are subrogated only to the rights of the obligee.

Appellants’ contention that under the doctrine of subrogation a surety is *always* entitled to subrogate to the rights of the principal obligor in order to acquire a pre-petition lien over assets owned by the principal evinces a fundamental misunderstanding of the doctrine. *See* Appellants’ Br., at 25. In its most basic application—where, as here, a surety merely makes payment under a bond—the doctrine permits a surety to subrogate only to the rights of the obligee of the bond and *not* to the rights of the principal obligor. As the Supreme Court has explained, subrogation entitles “one who has been compelled to pay a debt which ought to have been paid by another” to “exercise all the remedies

which the *creditor* [obligee] possessed against that other.” *Am. Sur. Co. v. Bethlehem Nat’l Bank*, 314 U.S. 314, 317 (1941) (emphasis added).

New York courts—including this Court—adhere to this understanding of the doctrine. See *In re Chateaugay*, 89 F.3d at 947; *Gibbs v. Hawaiian Eugenia Corp.*, 966 F.2d 101, 106 (2d Cir. 1992) (recognizing that “an insurer-subrogee stands in the shoes of its insured[-obligee]” after making payment to the insured under the terms of the insurance policy); *Am. Home Assurance Co. v. Enron Nat’l Gas Mktg. Corp. (In re Enron Corp.)*, 307 B.R. 372, 380 (S.D.N.Y. 2004) (“In the suretyship context, subrogation provides a secondary obligor [a surety] who performs the secondary obligation with the obligee’s rights with respect to the underlying obligation as though that obligation had not been satisfied.”) (internal quotation marks omitted); *Pittsburgh-Westmoreland Coral Co. v. Kerr*, 115 N.E. 465, 467 (N.Y. 1917) (“a person furnishing money to pay a debt should be substituted for the creditor”).¹¹

Indeed, *In re Chateaugay* is dispositive here. In that case, the surety issued workers’ compensation bonds to guarantee payment of the

¹¹ Judicial application of the doctrine, contrary to the Sureties’ contentions (see Appellants’ Br., at 26, 46), is consistent with the RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY. See Part I.C, *infra*.

principal obligor's employee obligations under the laws of certain states. 89 F.3d at 945–46. When the principal filed for bankruptcy, it halted workers' compensation payments and the surety was obligated to make payments to workers in the bonded states. *Id.* at 946. Although all workers' compensation demands were general unsecured claims prior to bankruptcy, in order to promote labor harmony the principal filed a plan of reorganization that guaranteed full payment to unpaid workers from the **non-bonded** states. *Id.* The plan, however, did not guarantee full payment to paid workers from the **bonded** states, or to creditors such as the surety that had derivative claims through these workers. *Id.* The surety objected to the plan and argued that its claims, like those of the unpaid workers, should be paid in full because its claims are the workers' claims through subrogation. *Id.* at 947.

This Court began its analysis by recognizing that, under the doctrine of subrogation, “[w]here property of one person is used in discharging an obligation owed by another * * * under such circumstances that the other would be unjustly enriched by the retention of the benefit conferred, the former is entitled to be subrogated to the position of the **obligee**.” *Id.* (emphasis added; quotation marks omitted). Because the

surety paid the workers' claims in the bonded states, the court held that it was subrogated to those workers' claims. *Id.* at 948. However, because those workers held only general unsecured claims both before and after the filing of the plan, the court concluded that the surety, "standing in their shoes, likewise was unable to obtain priority as a subrogee; instead it remained a general unsecured creditor with respect to the payments it had made." *Id.*

The *Chateaugay* Court further observed that "[t]his conclusion accords with the historical understanding of subrogation as an equitable remedy," and that "[i]t is no injustice to limit the surety's recovery to that of an unsecured general creditor." *Id.* The Court reasoned that "[u]nderstanding the risks of serving in that capacity, presumably [the surety] incorporated those risks into its rates when issuing policies and binding itself as surety." *Id.* "One of those risks was that its insured would go bankrupt and would be unable to meet its financial obligations to its employees," and the surety "would be left holding a claim in [bankruptcy] in which recovery is uncertain." *Id.* at 948–49. "Having

known these risks,” the Court explained, the surety “cannot now declare that it has been treated unfairly.” *Id.* at 949.¹²

In this proceeding, the Sureties’ only obligation under the Bond is to make payment for the milk upon the Commissioner’s demand for payment. *See* A-149; A-393–94, ¶ 5–6. This obligation is, in essence, no different from the surety’s obligation under the bond in *In re Chateaugay* to make payment to satisfy the principal obligor’s workers’ compensation obligations to its employees. By discharging the obligation Suprema owed, the Sureties are only “entitled to be subrogated to the position of the obligee.” *In re Chateaugay*, 89 F.3d at 947. And just as the *Chateaugay* surety subrogated to an unsecured claim from the obligees in that case, so too the Sureties here subrogate only to Allied’s unsecured claim. Furthermore, as this Court explained, such a conclusion fully “accords with the historical understanding of subrogation as an equitable remedy.” *Id.* at 948.

¹² *See also* *Gluck v. Seaboard Sur. Co (In re E. Freight Ways, Inc.)*, 577 F.2d 175, 180 (2d Cir. 1978) (“Normally, a surety to an insolvent principal is without recourse against the principal except insofar as the surety may ultimately receive some dividend from the bankruptcy proceedings.”).

B. This case is distinguishable from cases in the construction context, in which sureties may at times also be subrogated to the rights of the primary obligor.

Although both the bankruptcy court and the district court relied on *In re Chateaugay*—and *In re Enron*, which relies on *Chateaugay*—in their decisions, *see* SPA-18–19; SPA-50–51, it is telling that the Sureties do not address these cases, much less attempt to distinguish them from the present case.¹³ The Sureties rely, instead, on three cases from the construction industry, involving performance bonds and retainage funds, for the proposition that “New York has long recognized and enforced a surety’s equitable subrogation rights * * * to the rights of the primary obligor.” *See* Appellants’ Br., at 32–33 (citing *Mendelsohn v. Dormitory Auth. (In re QC Piping Installments, Inc.)*, 225 B.R. 553 (Bankr. E.D.N.Y. 1998); *Menorah Nursing Home, Inc. v. Zukov*, 153 A.D.2d 13, 548 N.Y.S.2d 702 (N.Y. App. Div. 1989); *Nat’l Shawmut Bank v. New York Amsterdam Cas. Co.*, 411 F.2d 843 (1st Cir. 1969)).¹⁴

¹³ The district court also quotes directly from *Bethlehem National Bank*, 314 U.S. at 317, to state that one “compelled to pay a debt which ought to have been paid by another is entitled to exercise all the remedies which the creditor possessed against that other,” SPA-50, but the Sureties ignore that case too.

¹⁴ The Sureties also cite to *Chemical Bank v. Meltzer*, 93 N.Y.2d 296 (1999), *see* Appellants’ Br., at 33, but that case recognizes only a

But as the bankruptcy court and district court both held, cases such as these, which arise from the construction industry and involve performance bonds and a surety's subrogation rights to retainage funds held by the obligee, involve fundamentally different issues than the subrogation arrangement at issue here and have no bearing on the present case. *See* SPA-17–18; SPA-22–23.

As the district court explained, it is only under certain limited circumstances—most commonly found in the construction industry—that a surety may subrogate to the rights of the principal obligor in order to receive any return performance owed by the obligee, such as disbursement from a retained fund, as consideration for the contract's completion. *See* SPA-51.¹⁵ Where the courts have recognized a surety's right to

surety's right to subrogate to the obligee's rights to title to real property securing the underlying obligation. *See* 93 N.Y.2d at 297 (holding that a secondary obligor who, like the Sureties in the present case, was required to pay the debt of the principal obligor and paid that debt, "has the right to be subrogated to the [obligee] under the bond").

¹⁵ The district court also noted that there is a second exception to the basic application of the doctrine of subrogation that permits a surety to subrogate to the rights of the principal obligor where the obligees "by their negligence, breach of contract or breach of warranty contributed to the [primary obligor's] default." SPA-53 (quoting from *Am. Ins. Co. v. Ohio Bureau of Workers' Comp.*, 577 N.E.2d 756 (Ohio App. 1991) (italics removed)). As the district court held—and the Sureties do not dispute—this exception "has no application here, because Allied did not in

subrogate to the principal obligor's rights in the construction-bonding context, two things are always present: First, the surety bond is a performance bond—and not merely a payment guarantee—that requires the surety to step in and actually perform the construction contract and pay all the laborers and materialmen in the event that the principal obligor-contractor defaults. Second, the contract permits the project owner or obligee of the bond to retain a percentage of estimated amounts due as security for the completion of all work covered by the contract, including the payment of all laborers and materialmen. *See, e.g., Pearlman*, 371 U.S. at 133–34; *Nat'l Shawmut Bank*, 411 F.2d at 844–45; *In re QC Piping Installations, Inc.*, 225 B.R. at 555–56; *Union Pac. Ins. Co. v. Mottner (In re The Massert Co.)*, 105 B.R. 610, 611–12 (W.D. Wash. 1989); *Menorah Nursing Home, Inc.*, 153 A.D.2d at 17.

Under these circumstances, a surety that performs the contract in the event of the principal's default may subrogate to the rights of both the obligee and the principal obligor, in order to receive the benefit of that performance—the retained funds. This is because, as the Supreme Court explained in *Pearlman*, the project owner “had a right to use the

any way contribute to or cause Suprema's default.” SPA-53; *see also* Appellants' Br., at 45.

retained fund to pay laborers and materialmen,” “the laborers and materialmen had a right to be paid out of the fund,” the principal contractor, “had he completed his job and paid his laborers and materialmen, would have become entitled to the fund,” and “the surety, having paid the laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it.” *Pearlman*, 371 U.S. at 141.¹⁶ In other words, until the surety stepped in to pay the laborers and materialmen, the project owner—and not the contractor—owned the retained fund. Had the contractor itself fulfilled its obligations under the contract, it would have been entitled to the fund; thus, by performing the contractor’s obligations, the surety was entitled to subro-

¹⁶ This rationale is restated in the paragraph Appellants quote from *National Shawmut Bank* on pages 33–34 of their brief:

But the surety *in cases like this* undertakes duties which entitle it to step into three sets of shoes. When, on default of the contractor, it pays all the bills of the job to date and completes the job, it stands in the shoes of the contractor *insofar as there are receivables due it* [retained funds]; in the shoes of laborers and material men who have been paid by the surety – who may have had liens; and, not least, in the shoes of the [project owner], for whom the job was completed.

411 F.2d at 845 (emphasis added).

gate to the rights of the principal obligor to receive the retained funds held by the project owner.

It is indisputable that these circumstances are not present in this case. The Sureties do not—nor can they—dispute that the Bond “was not a performance bond; it functioned as a payment guarantee providing the Commissioner with security guaranteeing the prompt payment of Suprema’s obligations to milk suppliers.” SPA-17; *see* SPA-53 (“[t]he Sureties merely paid the debt that Suprema owed”); A-149.

Moreover, “there is no retainage fund or similar segregation of funds” held by Allied—much less a fund consisting of the Bonded Transaction Assets—that Allied would have to turn over upon Suprema’s payment for the milk. SPA-53; *see* SPA-18 (noting that there was “no reserve account, hold back, retainage, segregated account or other separately identified property”). Indeed, there is nothing in the Allied Contract that provides for the establishment of such a fund or assigns to Allied the rights to any proceeds Suprema may derive from the milk in the event that Suprema fails to make payment for the milk. *See* A-655–79. Far from permitting Allied to retain any interest in the proceeds Suprema derived from the resale of milk, the Contract does not

even permit Allied to retain title to the milk itself after it delivered the milk. *See* A-659 (stating that Allied was to deliver an agreed-upon volume of milk each month and that upon delivery, “title thereto shall be deemed to have passed from SELLER [Allied] to PURCHASER [Suprema] ***free and clear of all liens***”) (emphasis added). Because Suprema acquired title, free and clear of any liens, to the milk at the moment that Allied delivered the milk, any default on payment for the milk had no effect on Suprema’s title to the milk or the proceeds thereof (the Bonded Transaction Assets).¹⁷ Simply stated, there was nothing owed by Allied at the time that the Sureties made payment under the Bond that is analogous to the retained funds that the project owner in the construction cases would have to turn over upon a surety’s performance of the contract.

In sum, because the Bond is not a performance bond and there is no retainage fund or similar segregation of funds withheld here,

¹⁷ Furthermore, because Allied did not retain title to the milk, it also did not possess a lien on the Bonded Transaction Assets and the Sureties could not subrogate to such a lien through Allied’s rights. *See* pages 54–55, *infra*. Indeed, as the bankruptcy court and the district court both found—and the Sureties do not dispute—in the event of a default in payment by Suprema, Allied’s sole recourse under the Allied Contract was to terminate the contract and sue for breach of contract to recover payments owed. *See* SPA-18; SPA-50–51.

“[n]othing about this case merits extension of the doctrine of subrogation to permit the Sureties to step into the shoes of Suprema.” SPA-53. The bankruptcy court and the district court clearly were correct in holding that, because the Sureties merely paid a debt Suprema owed to Allied, they can subrogate only to Allied’s unsecured claim against Suprema for repayment of that debt. *See Bethlehem Nat’l Bank*, 314 U.S. at 317 (“one who has been compelled to pay a debt which ought to have been paid by another is entitled to exercise all the remedies which the creditor possessed against that other”); *In re Chateaugay*, 89 F.3d at 947 (same).

C. Nothing about the result reached by the lower courts in this case is contrary to the rules set forth in the Restatement of Suretyship.

The Sureties contend that the analysis used by the lower courts in this case to hold that they subrogate only to the rights of Allied is contrary to the RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY (1996) (hereinafter “RESTATEMENT”). *See* Appellants’ Br., at 26, 46. But the RESTATEMENT, in fact, supports the lower courts’ conclusion.

Section 27 of the RESTATEMENT reiterates the rule enunciated by the Supreme Court in *Bethlehem National Bank*, 314 U.S. at 317: “[T]he

secondary obligor is subrogated to all rights of the *obligee* with respect to the underlying obligation to the extent performance of the secondary obligation contributed to the satisfaction.” RESTATEMENT § 27 (emphasis added). These rights include the secondary obligor’s right to “enforce, for its benefit, the rights of the obligee as though the underlying obligation had not been satisfied . . . against the principal obligor pursuant to the underlying obligation” (§ 28(1)(a)), as well as “against any interest in property securing * * * the obligation of the principal obligor” (§ 28(1)(c)). The secondary obligor’s right to enforce “against any interest in property securing * * * the obligation of the principal obligor,” is defined in Section 31(1), which states that “[f]or the purposes of a subrogated secondary obligor’s right to enforce for its benefit the obligee’s rights against property securing the underlying obligation (§ 28(1)(c)), performance *owed* by the obligee to the principal obligor pursuant to the contract creating the underlying obligation (“return performance”) is security for the underlying obligation.” *Id.* § 31(1) (emphasis added).

Although the Sureties are correct that this section of the Restatement quantifies the performing surety’s rights to include the “performance *owed* by the obligee to the principal obligor pursuant to the con-

tract creating the underlying obligation,” Appellants’ Br., at 48 (emphasis added), their contention that the Sureties thus “are entitled to the Bonded Transaction Assets, since that is the ‘return performance’ of Allied under the bonded contract” *id.*, ignores the very language of this section and the facts in the present case.

Section 31(1) clearly specifies that “property securing the underlying obligation” is the “performance owed by the obligee to the principal obligor pursuant to the contract creating the obligation,” or the obligee’s “return performance” under the contract. *See* RESTATEMENT § 31(1). In other words, *if* the obligee has a remaining obligation to perform upon satisfaction of the principal obligor’s obligation, then this *yet-to-be-performed* obligation is considered security for the underlying obligation, and the secondary obligor is entitled to enforce its interest in that return performance upon its discharge of the underlying obligation.

This reading of the section is supported by Comment a to Section 31, which further defines the meaning of “Return performance as security.” RESTATEMENT § 31 cmt. a. As the comment explains, “[w]hen the underlying obligation is the payment of money, the obligee typically supplies its performance—the extension of credit—first, and there is no

remaining obligation of the obligee to perform.” *Id.* In other words, the obligee has no return performance in such cases and there is no security to which the secondary obligor can subrogate. “When the underlying obligation is the provision of goods or services,” however, it is “common for the contract between the obligee and the principal obligor to provide that the obligee’s performance—typically the payment of money—is to occur either after the performance of the underlying obligation or in installments as the principal obligor completes portions of the underlying obligation.” *Id.* “In such a case, the ***unperformed*** portion of the obligee’s performance serves as security for the performance of the underlying obligation,” and if the secondary obligor discharges the underlying obligation, “the secondary obligor’s subrogation rights will allow the secondary obligor to reach the return performance of the obligee.” *Id.* (emphasis added).

The present case exactly parallels the first example discussed in the comment (*i.e.*, when the underlying obligation is the payment of money) because the underlying obligation is Suprema’s payment for the milk under the Allied Contract. Allied, the obligee, merely extended credit to Suprema when it delivered the milk because title to that milk

transferred to Suprema upon delivery. Thus, Allied had no remaining obligations to perform under the contract that can serve as security for the underlying obligation to which the Sureties, as the secondary obligor, could subrogate and enforce for its benefit.

The Sureties contend, without citing to any authority, that “it is of no consequence that Suprema received the obligee’s return performance,” before Suprema had to make payment for the milk. Appellants’ Br., at 49. But as the Restatement makes clear, the interest securing the underlying obligation to which a secondary obligor can subrogate is precisely the “performance *owed* by the obligee to the principal obligor.” RESTATEMENT § 31(1) (emphasis added); *id.* cmt. a (“the *unperformed* portion of the obligee’s performance serves as security for the underlying obligation”) (emphasis added).¹⁸ Moreover, in the construction cases cited by Appellants it is the *retained funds* held and owed by the project owner as return performance for the completion of the contract that

¹⁸ Although there is no dispute here that Allied owed no return performance after Suprema makes payment for the milk, it is instructive that in circumstances where the obligee did owe return performance and “the obligee pays the return performance to the principal obligor before such payment is owed under the contract between the principal obligor and the obligee, the ability of the secondary obligor to be made whole through subrogation may be impaired if the secondary obligor is called upon to perform.” RESTATEMENT § 31 cmt. c.

performance-bond sureties are entitled to through subrogation to the obligee's and the principal obligor's rights. *See Pearlman*, 371 U.S. at 133–34; *Nat'l Shawmut Bank*, 411 F.2d at 848; *In re QC Piping Installations, Inc.*, 225 B.R. at 568–69; *Union Pac. Ins. Co. v. Mottner (In re The Massert Co.)*, 105 B.R. 610, 611 (W.D. Wash. 1989); *Menorah Nursing Home, Inc.*, 153 A.D.2d at 17. Because Allied owed no return performance in the present case, the Sureties simply cannot subrogate to the rights of Suprema.

* * * * *

Thus, because the Sureties are subrogated only to the rights of Allied, not to those of Suprema, the decisions of the lower courts are correct and should be affirmed.

II. The Sureties Do Not Possess An Equitable Lien Over The Bonded Transaction Assets Under The Doctrine Of Subrogation

Even if the Sureties did subrogate to any of the rights of the principal obligor, Suprema, in this case (*but see* Part I, *supra*), they nonetheless would not possess a superior interest to the Bonded Transaction Assets.

The Sureties argue that they acquired an equitable lien over these assets of Suprema’s—meaning, over the sum of money that Kraft and Dairy Lea paid to Suprema—under the doctrine of subrogation because such a lien “arise[s] in *every* surety matter.” Appellants’ Br., at 25 (emphasis added); *see id.* at 34. According to the Sureties, a “performing surety’s right of subrogation is supported by an equitable lien protecting its interests in the proceeds of the supported transaction, which are considered the surety’s collateral” for its obligations under the bond. *See* Appellants’ Br., at 25.

But as this Court’s decision in *In re Chateaugay* clearly demonstrates, a surety does not always acquire an equitable lien under the doctrine of subrogation. *See* 89 F.3d at 948 (holding that the surety obtained only an unsecured claim for payment under the doctrine of subrogation). No such lien exists here, and thus the Bank Group’s secured claim to all of Suprema’s assets is superior to the Sureties’ unsecured claim.

Although a performing surety may be entitled to reimbursement from the principal obligor, *see* RESTATEMENT § 22(1), that right to reimbursement does not mean that any *proceeds* the principal derives from

such transactions serves as collateral for performance of the surety's obligations. To the contrary, the right to reimbursement arises only after the surety satisfies the principal's obligations in full, *see* RESTATEMENT § 22(2), and is merely the right to bring an unsecured claim against the principal, which if successfully litigated, would be paid out from the principal's general funds (or in the bankruptcy context, from the principal's bankruptcy estate). Moreover, the principal has no duty to reimburse the surety to the extent that "bankruptcy law relieves the principal obligor of that duty." RESTATEMENT § 24(1)(a). And as with any unsecured claim, a claim for reimbursement does not operate to exclude any funds from the principal's bankruptcy estate. *See* 11 U.S.C. § 507.

There are, to be sure, certain situations in which courts have recognized a surety's right to acquire an equitable lien under the doctrine of subrogation. However, these cases—again most commonly arising in the construction industry and involving performance bonds—all involve equitable liens fashioned by the courts to permit the surety to obtain ***retained funds*** held by the obligee as security for the underlying obligation (*i.e.*, the principal obligor's obligations) and not for the surety's

obligations.¹⁹ *See e.g., Pearlman*, 371 U.S. at 141; *Nat'l Shawmut Bank*, 411 F.2d at 845; *see also* RESTATEMENT § 31 cmt. a (“sums earned by the principal obligor but not yet paid by the obligee,” commonly labeled “retainages,” “serve[] as security for the performance of the underlying obligation”).²⁰

¹⁹ The Sureties’ contention that the proceeds Suprema derived from the milk are considered collateral for their obligations under the Bond, solely by virtue of the suretyship, is belied by the fact that the Sureties found it necessary to execute the Indemnity Agreements to secure full reimbursement from Suprema via an assignment claim or via a trust claim to the Bonded Transaction Assets. If the proceeds derived from a bonded transaction automatically serve as collateral for a surety’s obligation under the common law of suretyship, as the Sureties appear to contend, then there would be no need for the Sureties, or any surety for that matter, to execute such agreements to secure their obligations.

²⁰ Indeed, *every* case from the construction industry that the Sureties cite in support of their argument involves a performance bond and an equitable lien over funds retained by the obligee as security for the underlying contract. *See First Indem. of Am. Ins. Co. v. Modular Structures, Inc. (In re Modular Structures, Inc.)*, 27 F.3d 72, 75 (3d Cir. 1994) (cited in Appellant’s Br., at 31); *J.J. Mickelson v. Aetna Cas. & Sur. Co. (In re J.V. Gleason Co.)*, 452 F.2d 1219, 1220–21 (8th Cir. 1971) (cited in Appellant’s Br., at 35 n.14); *Trinity Universal Ins. Co. v. United States*, 382 F.2d 317, 320-21 (5th Cir. 1967) (cited in Appellants’ Br., at 38 n.16); *Am. States Ins. Co. v. United States*, 324 B.R. 600, 605 (N.D. Tex. 2005) (cited in Appellant’s Br., at 35 n.14); *Sch. Bd. of Broward Cty. v. J.V. Construction Corp.*, No. 03-60005-Civ-MOR/GAR, 2004 WL 1304058, at *13, 19 (S.D. Fla. Apr. 23, 2004); *United States Fid. & Guar. Co. v. APAC-Kansas, Inc.*, 151 F. Supp. 2d 1297, 1300-01 (D. Kan. 2001) (cited in Appellant’s Br., at 34–35); *United Pac. Ins. Co. v. Mottner (In re Massert Co.)*, 105 B.R. 610, 611–12 (W.D. Wash. 1989) (cited in Appellants’ Br., at 37 n.15); *First Ala. Bank v. Hartford Accident &*

As the Supreme Court explained in *Pearlman*, where there is a retained fund held by the project owner as security for the principal obligor's performance of the underlying contract, the principal obligor does not own those funds but instead would become entitled to those funds *if*

Indem. Co., 430 F. Supp. 907, 909 (N.D. Ala. 1977) (cited in Appellant's Br., at 35 n.14); *O'Rourke v. Coral Constr., Inc. (In re E.R. Fegert, Inc.)*, 88 B.R. 258, 260 n.1 (B.A.P. 9th Cir. 1988) (cited in Appellant's Br., at 35 n.14 & 38 n.16); *John's Insulation, Inc. v. Hartford Accident & Indem. Co. (In re John's Insulation, Inc.)*, 221 B.R. 683, 688 (Bankr. E.D.N.Y. 1998) (cited in Appellants' Br., at 38 n.16); *In re QC Piping Installations, Inc.*, 225 B.R. at 555 (cited in Appellants' Br., at 40); *Transamerica Ins. Co. v. Barnett Bank*, 540 So.2d 113, 117 (Fla. 1989) (cited in Appellant's Br., at 35); *Fid. & Cas. Co. v. Cent. Bank*, 409 So.2d 788, 790 (Ala. 1982) (cited in Appellant's Br., at 35 n.14); *Third Nat'l Bank v. Highlands Ins. Co.*, 603 S.W.2d 730, 734 (Tenn. 1980) (cited in Appellant's Br., at 35 n.14); *Alaska State Bank v. Gen. Ins. Co.*, 579 P.2d 1362, 1368 (Alaska 1978) (cited in Appellant's Br., at 35 n.14); *Fin. Co. v. United States Fid. & Guar. Co.*, 353 A.2d 249, 251 (Md. 1976); *Mid-Continent Cas. Co. v. First Nat'l Bank & Trust Co.*, 531 P.2d 1370, 1371 (Okla. 1975) (cited in Appellant's Br., at 35 n.14); *United States Fid. & Guar. Co. v. First State Bank*, 494 P.2d 1149, 1150 (Kan. 1972) (cited in Appellant's Br., at 35 n.14); *Canter v. Schlager*, 267 N.E.2d 492, 493 (Mass. 1971) (cited in Appellant's Br., at 35 n.14); *Travelers Indem. Co. v. Clark*, 254 So.2d 741, 745–46 (Miss. 1971) (cited in Appellant's Br., at 35 n.14); *Jacobs v. N.E. Corp.*, 206 A.2d 49, 50 (Pa. 1965) (cited in Appellant's Br., at 35 n.14); *United States Fid. & Guar. Co. v. Triborough Bridge Auth.*, 74 N.E.2d 226, 228 (N.Y. 1947) (cited in Appellant's Br., at 36); *N.M. State Highway & Transp. Dep't v. Gulf Ins. Co.*, 996 P.2d 424 (N.M. Ct. App. 1999) (cited in Appellants' Br., at 38 n.16); *Argonaut Ins. Co. v. C & S Bank*, 232 S.E.2d 135, 140 (Ga. Ct. App. 1976) (cited in Appellant's Br., at 35 n.14); *Lake Steel Equip. Rental Inc. v. People*, 562 N.Y.S. 2d 921, 922 (N.Y. Sup. Ct. 1990) (cited in Appellant's Br., at 36); *U.S. Cas. Co. v. Met. Contracting Corp.*, 158 N.Y.S.2d 117, 120 (N.Y. Sup. Ct. 1956) (cited in Appellant's Br., at 36).

it fully performs the contract. *See* 371 U.S. at 141. Unless and until the principal satisfies all its obligations, the project owner owns those funds and has a right to apply the funds toward the costs associated with the completion of the project. *Id.* By stepping into the principal’s shoes to discharge the principal’s obligations, the performing surety also steps into those same shoes so as to acquire the benefits of that performance—that is, entitlement to the retained funds. *Id.* Thus, the surety subrogates to an equitable lien over these retained funds because the principal obligor does not possess those funds and those funds equitably should belong to the surety, not to the principal obligor or the project owner. *Id.*; *see also Nat’l Shawmut Bank*, 411 F.2d at 845 (“[w]hen, on default of the contractor, [the surety] pays all the bills of the job to date and completes the job, it stands in the shoes of the contractor, ***insofar as there are receivables due it***”) (emphasis added).²¹

²¹ Although the Sureties are correct that some courts have applied *Pearlman*’s holding in cases arising outside of the construction-industry context, *see* Appellants’ Br., at 38 & n. 17, those cases also merely recognized a surety’s subrogation to an equitable lien over funds held as security for the underlying obligation, that is funds to which the principal obligor would be entitled only if it discharged all its obligations. *See Brock v. Career Consultants, Inc. (In re Career Consultants, Inc.)*, 84 B.R. 419, 420 (Bankr. E.D. Va. 1988) (involving funds withheld to the Service Contract Act to ensure payment to employees); *In re Frank*

By analogy, the only way that the Sureties could subrogate to an equitable lien over anything in the present case would be if Allied had retained title to the milk, or to some other assets derived from that milk, **and** if Allied had been obligated to turn over those assets or title to the milk upon Suprema's payment for the milk. But the Allied Contract clearly and unambiguously states that Allied does not retain either title to the milk or any specific funds derived from the sale of that milk. *See* A-650 (providing that Allied was to deliver an agreed-upon volume of milk each month and that upon delivery, "title thereto shall be deemed to have passed from SELLER [Allied] to PURCHASER [Suprema] free and clear of all liens"). As discussed above, *see* pages 42, 46–47, *supra*, Allied performed **all** its obligations due under the Allied

Mossa Trucking, Inc., 65 B.R. 715, 718–19 (Bankr. D. Mass. 1985) (same); *Am. Ins. Co. v. Ohio Bureau of Workers' Compensation*, 577 N.E.2d 756, 758–59 (Ohio App. 1991) (involving funds from an excess indemnity insurance policy entered into by the principal to which the principal would have been entitled if it had fully performed its obligations). The Sureties are mistaken that the court in *Bruce v. Martin*, 1994 WL 537888, at *1 (S.D.N.Y. Oct. 3, 1994), applied *Pearlman* to recognize a surety's equitable lien under the doctrine of subrogation. *See* Appellants' Br., at 38 n.17. In that case, the court made no mention of an equitable lien but merely held that a surety who made payment on a financial guaranty bond had a right to reimbursement from the principal obligor under the doctrine of subrogation and that the surety's rights were limited to the amount it paid to the obligee. 1994 WL 537888, at *5.

Contract—the delivery of the milk and the transfer of title to that milk—*before* Suprema’s underlying obligations arose. There simply is no return performance owed by Allied against which an equitable lien could attach. Simple logic dictates that the Sureties cannot obtain such a lien through subrogation under these facts.

Thus, because Suprema possessed title, “free and clear of all liens,” A-650, to the milk—and by extension to the proceeds Suprema derived from the sale of that milk—these assets are part of Suprema’s bankruptcy estate and thus subject to the Bank Group’s first priority lien. As the Sureties acknowledge in their opening brief, “[a] bankrupt’s estate is defined to include ‘all legal or equitable interests of the debtor in property as of the commencement of the case.’” Appellants’ Br., at 28 (quoting 11 U.S.C. § 541(a)(1) (2006)); *see also Sayno Elec., Inc. v. Howard’s Appliance Corp. (In re Howard’s Appliance Corp.)*, 874 F.2d 88, 93 (2d Cir. 1989) (“Under section 541 of the Bankruptcy Code, a debtor’s legal and equitable interests in property, ‘as of the commencement of the case,’ constitute ‘[p]roperty of the estate.’”) (quoted in Appellants’ Br., at 29). Funds owned by the debtor are “no different from cash deposited in [the debtor’s] general bank accounts, to which the Sureties

would have no priority relative to [the debtor's] general unsecured creditors." *In re Enron Corp.*, 307 B.R. at 382; *see also In re Nemko, Inc.*, 143 B.R. 980, 986 (Bankr. E.D.N.Y. 1992) ("Under the broad definition of property in Section 541(a) of the Bankruptcy Code, the Debtor's interest in the account[s] receivable is property of the estate.").²² More-

²² Furthermore, this case is indistinguishable from the many cases arising in the construction industry where courts have held that a surety could not acquire a lien on funds earned and *owned* by the principal at the time it defaulted on its obligations. *See, e.g., Ind. Lumbermens Mut. Ins. Co. v. Constr. Alternatives, Inc. (In re Constr. Alternatives, Inc.)*, 2 F.3d 670, 674 (6th Cir. 1993) (finding that debtor obtained rights to the final payment on a contract with school board where several subcontractors remained unpaid because the debtor did not owe anything on the contract with the school district); *Acuity v. Planters Bank, Inc.*, 362 F. Supp. 2d 885, 894 (W.D. Ky. 2005) ("Only a surety who fully performs on a payment or performance bond may enforce this equitable interest and only then against unpaid funds or those retained as security on a construction contract."); *In re Nemko*, 143 B.R. at 986 (amount owed to debtor for work completed pursuant to a contract constituted "property of the estate" even though the project owner the project had a contractual right, but not an obligation, to delay payment until all subcontractors and suppliers had been paid); *Slutsky v. City of Cincinnati (In re Wm. Cargile Contractor, Inc.)*, 203 B.R. 644, 646 (Bankr. S.D. Ohio 1996) (final payment held by the city for work that debtor completed pre-petition belonged to debtor and was property of the debtor's bankruptcy estate where construction contract contained no provision for a retainage); *Am. Cas. Co. v. Town of Shattuck*, 228 F. Supp. 834, 841 (W.D. Okla. 1964) (distinguishing the case from *Pearlman* and other cases where "retainage funds pertaining to the project involved were still in hands of the" obligee and noting that "[n]o case from the United States Supreme Court has been presented nor has one been found in which rights of subrogation or exoneration have been

over, it is undisputed that the Bank Group has a perfected priority lien on all of Suprema's assets and property, including accounts receivable, inventory, contract rights, and deposits. *See* SPA-5; A-391. Accordingly, the lower courts were plainly correct in holding that the Bonded Transaction Assets—and in particular the proceeds Suprema received from the sale of milk to DMS—were not subject to an equitable lien in favor of the Sureties, and were properly distributed to the Bank Group.

III. The Sureties' Subrogation Rights Did Not Arise Until After They Made Payment Under The Bond.

As the lower courts correctly held, *see* SPA-17, SPA-25–26, even if the Sureties were to step into the shoes of Suprema through subrogation, *but see* Part I, *supra*, and even if through that application of the subrogation doctrine the Sureties were to acquire an equitable lien over the Bonded Transaction Assets, *but see* Part II, *supra*, that lien would not have arisen until the Sureties were called upon to pay Allied—long after Suprema's bankruptcy. As a result, such a (hypothetical) lien would not be superior to the Bank Group's secured interest in Su-

upheld in a payment bond surety against a public entity not having specific construction or retainage funds in its possession"); *In re Glover Constr. Co.*, 30 B.R. 873 (Bankr. W.D. Ky. 1983) (the performing debtor was entitled to progress payments once they are earned on a construction contract).

prema's bankruptcy estate. The Sureties' argument to the contrary is wholly without merit.

1. Looking first at the Sureties' rights via subrogation to Allied, the Sureties do not challenge the lower courts' holdings that by virtue of these rights the Sureties may only enforce Allied's unsecured claim for payment for the milk. As the lower courts explained, that claim is a contingent or inchoate claim because the Sureties made payment under the Bond more than three months *after* Suprema's filing. *See* SPA-17–18; SPA-50–51; SPA-54.²³ But even if this unsecured claim were not an inchoate claim when Suprema filed for bankruptcy, the claim neither op-

²³ Suprema's mere failure to pay Allied on February 16, 2002, in compliance with the Northeast Order did not, and could not, trigger any enforcement rights on the part of the Sureties under the terms of the Allied Contract, the Bond, or the applicable New York statute governing the relationship between milk purchasers. The Sureties' obligation to pay under the Bond was not triggered by Suprema's failure to pay for the milk; unless and until Allied sought payment from the Commissioner, *and* the Commissioner investigated and certified Allied's claim, *and* the Commissioner demanded payment under the Bond, the Sureties had no obligation to do anything. *See* N.Y. AGRIC. & MKTS. LAW § 258-b; A-150. Further, any number of intervening events could have resulted in payments made to Allied prior to the Commissioner invoking the Bond remedy. *See* SPA-17. Unless and until the Commissioner demanded payment under the Bond and the Sureties made the payment, the Sureties had no claim. Thus, at the time Suprema filed for bankruptcy relief, the Sureties had nothing more than a contingent unsecured claim. *See* SPA-18, 19; 11 U.S.C. § 506.

erates to exclude the Assets from Suprema’s bankruptcy estate nor defeats the Bank Group’s priority liens over the Assets. *See* SPA-18; SPA-50–51; pages 28, 36, *supra*.

2. Even if the Sureties were entitled to use the doctrine of equitable subrogation to step into the shoes of Suprema, and even if they could thereby acquire an equitable lien over the Bonded Transaction Assets, such a lien would not arise until the Sureties complied with the Commissioner’s demand for payment—that is, after the bankruptcy filing.

This Court, as well as numerous other courts, have consistently held that a surety’s equitable rights under the doctrine of subrogation arise only in a contingent sense upon execution of the bond; it is not enforceable until the surety actually suffers a loss. *See, e.g., Grant Thornton v. Syracuse Sav. Bank*, 961 F.2d 1042, 1047 (2d Cir. 1992) (“[S]ubrogation may be utilized only after full payment of the debt owed by the subrogor.”).²⁴ Under this rule, any rights the Sureties acquired

²⁴ *See also Reliance Ins. Co. v. U.S. Bank*, 143 F.3d 502, 506 (9th Cir. 1998) (“At common law, a surety does not become subrogated to its principal’s right to payment from a third party until the surety performs the principal’s obligations.”); *Greenfield, Stein & Senior, LLP v. Daley (In re Daley)*, 222 B.R. 44, 46–47 (Bankr. S.D.N.Y. 1998) (“An es-

through subrogation—even if these rights included an equitable lien—were not enforceable until the Sureties incurred an actual loss.

The Sureties cite two cases to argue that they are entitled to subrogate to a pre-petition lien over the Bonded Transaction Assets even though they made payment to the Commissioner after Suprema filed for bankruptcy. See Appellants’ Br., at 39–41 (citing *United Pacific Ins. Co. v. Mottner (In re Massart Co.)*, 105 B.R. 610 (W.D. Wash. 1989), and *Mendelsohn v. Dormitory Auth. of the State of New York (In re QC Piping Installations, Inc.)*, 225 B.R. 553 (Bankr. E.D.N.Y. 1998)). But contrary to the Sureties’ mischaracterization of *In re QC Piping Installations*, the surety in that case had already performed all of its obligations **before** the debtor filed for bankruptcy. See 225 B.R. at 568 (noting that the surety completed the underlying project and paid all subcontractors

essential prerequisite to the right of equitable subrogation is that the person seeking subrogation must have made a payment of another’s obligation.”) (quotation marks omitted); *In re V. Pangori & Sons, Inc.*, 53 B.R. 711, 723 (Bankr. Mich. 1985) (“Until payments were made on the bankrupt’s behalf, the surety’s claims were contingent and unenforceable; before any of those rights ripened into an enforceable lien, the trustee acquired the rights of a judicial lien creditor in the retainage held by the city.”); *Safeco Ins. Co. v. State of N.Y.*, 392 N.Y.S.2d 976, 978 (N.Y. Ct. Cl. 1977) (noting that a surety’s “lien arises upon execution of the bond although it does not become enforceable until after the surety suffers a loss by making payments pursuant to its obligation under the bond”).

“*prior* to the [debtor’s] filing”) (emphasis added). And while the court in the other case, *In re Massert*, did hold that the surety in that case subrogated to an equitable lien over retained funds that became enforceable before the surety suffered any losses, *see* 105 B.R. at 613, that decision, which was not reviewed by a higher court, is unique to the best of the Bank Group’s knowledge, and is plainly incorrect. Not only has no other court adopted that holding, but more important that holding is inconsistent with the broadly recognized rule that a surety’s equitable rights under the doctrine of subrogation are not enforceable until the surety suffers actual loss. *See Grant Thornton*, 961 F.2d at 1047; *see also* cases cited in n.22, *supra*.

In any event, *In re Massart* and *In re QC Piping* merely underscore the untenable nature of the Sureties’ argument. Both cases involve funds withheld by a project owner as security for the principal obligor’s full performance of the underlying construction contract. Each case held that the performing surety subrogated to an equitable lien over those retained funds. *See* 105 B.R. at 613; 225 B.R. at 568. But by contrast, the Bonded Transaction Assets were not retained by Allied or otherwise designated as security for Suprema’s payment for the milk;

thus the doctrine of subrogation does not impose an equitable lien in the Sureties' favor over these Assets. *See* Part II, *supra*. Without any entitlement to an equitable lien over the Assets, the Sureties simply cannot avail themselves of the same rights as those held by the sureties in *In re Massart* and *In re QC Piping*.

Thus, the Sureties subrogation rights consist only of Allied's right to enforce an unsecured claim for payment for the milk, which arose *after* they made payment under the Bond. Accordingly, the lower courts were clearly correct that the Sureties' subrogation rights do not exclude the Assets from Suprema's bankruptcy estate or defeat the Bank Group's priority liens over the Assets.

CONCLUSION

For the foregoing reasons, this Court should affirm the bankruptcy court's grant of summary judgment in favor of the Bank Group.

Respectfully submitted,

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Dated: December 5, 2007.

CERTIFICATE OF COMPLIANCE

Pursuant to Fed. R. App. P. 32(a) counsel for Appellees hereby certify as follows:

1. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because it contains 13,992 words, excluding the parts of the brief exempted by Fed. R. App. R. 32(a)(7)(B)(iii); and

2. This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type-style requirements of Fed. R. App. P. 32(a)(6) because it has been prepared in a proportionally spaced typeface using Microsoft Word 2002 in 14-point Century Schoolbook.

Dated: December 5, 2007.

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ADDENDUM: N.Y. AGRIC. & MKTS. LAW § 258-b.

Prompt payment for milk purchases; security funds; bonding of milk dealers.

2. Prompt payment for milk.

(a) Every milk dealer shall: on or before the last day of each month, or such date of payment as established by a federal milk marketing order regulating the marketing of milk in the state or a state milk marketing order promulgated pursuant to section two hundred fifty-eight-m of this article, whichever is earlier, pay for all milk received from producers during the first fifteen days of such month based upon a price or formula as determined by the commissioner and every such milk dealer shall, on or before the twentieth day of each month, or such date of payment as established by a federal milk marketing order regulating the marketing of milk in the state or a state milk marketing order promulgated pursuant to section two hundred fifty-eight-m of this article, whichever is earlier, pay the balance owed producers for milk received during the preceding month.

* * *

(c) Any producer who does not receive payment for milk sold or delivered to a milk dealer, within the time prescribed in paragraph (a) of this subdivision, shall promptly notify the commissioner of such fact.

* * *

5. Claims against mandatory minimum surety bond and milk producers security fund.

* * *

(c) The commissioner shall examine the claims so filed, determine after hearing upon reasonable notice to the claimant and to the defaulting dealer the amount due upon such claims, and certify the amount due each claimant, provided, however, that no hearing shall be required with respect to a claim in which the defaulting dealer does not dispute liability and the claimant and defaulting dealer agree and stipulate to the amount found by the department to be payable on said claim.

* * *

(d) The commissioner's determination certifying the amount due each claimant shall be final unless the defaulting milk dealer or the claimant shall institute a proceeding pursuant to article seventy-eight of the civil practice law and rules within thirty days from the date of personal service of a copy of the written determination upon the milk dealer and producer affected thereby. If after the expiration of the thirty day period the commissioner's determination has not been stayed by the supreme court in a proceeding instituted to review it, the commissioner shall bring an action on the bond or bonds claims and, to the extent that such funds are insufficient to pay the amount due, direct the comptroller to pay the claimants from the moneys available in the milk producers security fund. For the purposes of any action brought on a bond, the commissioner's determination shall be presumptive evidence of the facts stated therein.

* * *

6. Surety bonds.

(a) Each milk dealer who buys, receives or otherwise handles milk received from producers may execute and file with the commissioner a surety bond in lieu of participation in the milk producers security fund and the filing of a surety bond or bonds pursuant to subdivision three of this section. The bond shall be executed by a surety company authorized to do business in this state and shall be approved by the commissioner. The bond shall be conditioned for the prompt payment of all amounts due to producers for milk sold or consigned by them to such milk dealer during the license year and all amounts due to the equalization or producer settlement fund of any order promulgated by the commissioner pursuant to section two hundred fifty-eight-m or two hundred fifty-eight-n of this article or to the equalization or producer settlement fund of a federal milk marketing order.

* * *

9. Claims against bond or alternative security.

Claims by producers against a dealer who had filed a bond or alternative security shall be processed by the commissioner in the same manner as is provided in subdivision five hereof with respect to claims

against the producers security fund and such claims shall be subject to the same limitations. The commissioner's determination certifying the amounts due claimants shall be subject to judicial review in the same manner and subject to the same limitations. * * * In the case of a dealer who has filed a surety bond, the commissioner may bring an action on the bond, and for the purposes of such action his determination certifying the amounts due shall be presumptive evidence of the facts therein stated.

* * *