



**BANKRUPTCY ISSUES IN GENERAL  
CONTRACTOR, SUBCONTRACTOR, AND  
OWNER BANKRUPTCIES**

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# OVERVIEW

## General Bankruptcy Issues in Construction Projects

- The Automatic Stay
- Property of the Estate
- Insurance Policies and Proceeds
- Mechanics' Liens
- Sale Issues

# OVERVIEW

## Executory Contracts in Bankruptcy

- Assumption / Rejection of Contracts
- Adequate Assurance of Future Performance
- Right to Terminate a Contractor
- Right of Contractor to Complete

# OVERVIEW

## Claims and Causes of Action in a Bankruptcy Proceeding

- Claims Against the Debtor
- Claims Against a Debtor's Payment Bond
- Reclamation
- Setoff and Recoupment
- Preference Actions

# Bankruptcy Overview

- Bankruptcy Basics
- Chapter 7 v. Chapter 11
- Absolute Priority Rule

# The Automatic Stay – 11 U.S.C. § 362

- What is the Automatic Stay?
- Nature and Purpose of the Automatic Stay
- Impact of the Stay Provisions: the Automatic Stay in bankruptcy stops certain actions and stays certain actions
  - Difficult issues in multi-party construction lawsuits, with sureties
  - Tricky issues with mechanics liens, perfection, and the statute of limitations
  - Prevents termination of contracts without stay relief

# Are Pending Legal Actions Stayed?

- If Debtor is a defendant (includes counter-claims, cross-claims, etc.)
  - Yes, clear language of 11 U.S.C. 362(a)
  - Maybe can get discovery if solely into claims against others – *In re Miller*, 262 B.R. 499 (9<sup>th</sup> Cir. BAP 2001)
- If Debtor is a plaintiff (includes counter-claims, cross-claims, etc.)
  - No, *In re Merrick*, 175 B.R. 333 (9<sup>th</sup> Cir. BAP 1994)

# Examples

- Debtor's cross-claim against co-defendant for contribution is not stayed – *Boone v. Beacon Bldg. Corp.*, 613 F.Supp. 1151, 1155 (D.N.J. 1985)
- Debtor may not appeal adverse ruling in action commenced by non-debtor party without obtaining relief from stay – *Farley v. Henson*, 2 F.3d 273 (8<sup>th</sup> Cir. 1993)



# Multiple Party Litigation

- Co-Defendants? (Except in Chapter 12 or 13)
  - *McCartney v. Integra Nat. Bank N.*, 106 F.3d 506, 509-10 (3d Cir. 1997) – “Although the scope of the automatic stay is broad, the clear language of section 362(a) stays actions only against a ‘debtor.’ As a consequence, ‘[i]t is universally acknowledged that an automatic stay of proceedings accorded by § 362 may not be invoked by entities such as sureties, guarantors, co-obligors, or others with a similar legal or factual nexus to the ... debtor.’”
  - 9B Am. Jur. 2d Bankruptcy § 1747
  - Generally no, but in some unique circumstances it can.

# Property of the Estate

- What is considered property of the estate?
- What isn't?

# Insurance Policies and Proceeds

- Debtor's rights to recover under its insurance policies are not impaired by its bankruptcy filing
- Debtor's third party policies are property of estate
- Policy proceeds are generally not property of estate
- Claimants under Debtor's policies must generally seek relief from stay and must assure that estate will be held harmless.

# Mechanics Liens

- Mechanics Lien – creature of state law
  - State law statutory protection for general contractors, sub-contractors, laborers, and material men to give them security on property they have improved with their labor
  - Generally strictly construed
  - Generally requires notices, and various actions by specific times or else the right is waived
  - Extremely technical and varies based on state law

# Significance of Mechanics Lien

- Most state law mechanics liens relate back in priority to some earlier event
- Priority battles – who wins versus prior perfected secured creditor?
  - Issue of state law:
    - Kansas – *In re Corbin Park, L.P.*, 470 B.R. 573 (10<sup>th</sup> Cir. BAP 2012) – priority dates to date of earliest unsatisfied work under K.S.A. 60-1101
    - Missouri – *In re Trilogy Development Company*, 437 B.R. 683 (Bankr. W.D. Mo. 2010) – priority dates back to the first spade of work (regardless if paid or unpaid)

# What is the effect of Bankruptcy on a Mechanics Lien?

- Automatic Stay Issues – what is stayed and what is not?
  - Lawsuits?
  - Perfection actions?
  - What can proceed?

Required Filings – 546(b) statements

Tolling Issues - Are certain actions tolled during the bankruptcy or not?

# Language of Section 362(b)

- Automatic Stay does not prevent...
  - 362(b)(3) - any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee's rights and powers are subject to such perfection under section 546 (b) of this title or to the extent that such act is accomplished within the period provided under section 547 (e)(2)(A) of this title;

# 11 U.S.C. § 546(b)

- Under Section 546(b), the debtor's or trustee's rights and powers are subject to any applicable law:
  - That permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection.
  - *If* the applicable law requires seizure or commencement of an action to establish perfection, **and** no seizure or commencement has taken place prior to the petition date, **then** perfection is maintained by giving notice within the time fixed by such law for seizure or commencement.



# Inchoate Liens as of the Bankruptcy Filing

- Liens That Have Not Been Filed Yet
- State Law Examples
  - Vermont Law – *In re APC Constr., Inc.*, 112 B.R. 89 (Bankr. D. Vt. 1990) - an inchoate lien exists the moment a contractor commences visible work and an intervening bankruptcy does not alter it – allowing post-petition filing of a lien, but not enforcement of it.
  - Alabama Law – *In re Cook*, 382 B.R. 282 (Bankr. N.D. Ala. 2008) – 362(b)(3) exception is for perfection of lien post-petition, not enforcement of lien post-petition.

# Filed But Unenforced Liens

- Filing an action post-petition against the Debtor is a violation of the automatic stay
- But most state law statutes require filing of a lawsuit to enforce mechanics liens within a certain time, but those suits are stayed
  - Is commencement of a suit required to maintain perfection?
    - If yes 546(b) statement required to be filed in the bankruptcy
    - If no then enforcement of suit stayed and a 546(b) statement need not be filed
    - See *Concrete Structures, Inc. v. Tidewater Crane and Rigging Co.*, 261 B.R. 627 (D. Va. 2001)

# Filed Liens, But Unprosecuted as of Bankruptcy Filing – 546(b) Statement

**In re Triliogy Development, Inc., 468 B.R. 854 (Bankr. W.D. Mo. 2012)**

- Missouri law – although Missouri law imposes a time limitation for bringing an action to foreclose a lien, it is not part of lien perfection process
- Therefore architect (and their law firm) did not need to file 546(b) notice to continue perfection of lien post-petition

***In re Birdview Satellite Communications, Inc., 90 B.R. 465 (Bankr. D. Kan. 1988)***

- Kansas law – also imposes a time limit by which a suit must be brought to enforce a lien, and it is part of the perfection process
- Therefore architect (and their law firm) did need to file a 546(b) notice to continue perfection of tis lien

# Tolling Under 11 U.S.C. § 108(c)

- Related Issue to What is Stayed Under Section 362
  - What actions or claims are tolled against the Debtor under 11 U.S.C. 108(c) by the filing of a bankruptcy?
  - Issue centers on who filed bankruptcy – owner, general contractor or sub-contractor and if they are an indispensable party in the state law proceeding enforcing the lien

# Example Cases

## ***Diamond Hill Inv. V. Shelden, 767 P.2d 1005 (Wyo. 1989)***

- Architect sued on contractors lien, but owner filed bankruptcy before amended complaint naming mortgage holders was filed.
- Bankruptcy was later dismissed, Architect restarted suit with mortgage holders.
- Mortgage holders asserted statute of limitations as suit was not stayed under 108.

## ***Hamel v. American Continental Corp., 713 P.2d 1152 (Wyo. 1986)***

- Employees of contractor filed foreclosure action 183 days after filing the lien, arguing it was timely, as contractor had filed bankruptcy, staying time for filing the suit.
- Owner asserted statute of limitations defense

# Results

## *Diamond Hill Inv. V. Sheldon*, 767 P.2d 1005 (Wyo. 1989)

- Was 180 day deadline stayed under Section 108 of the Code by owners bankruptcy for suit against mortgage holders?
- Key is who is indispensable party – owner is under WY law, so action was stayed and thus amendment after dismissal was timely

## *Hamel v. American Continental Corp.*, 713 P.2d 1152 (Wyo. 1986)

- Was 180 day deadline stayed under Section 108 of the Code by contractors bankruptcy suit against owner?
- Key is who is indispensable party – contractor is generally not under WY law, so action not stayed, and suit was untimely

# State Law Dependent

- Answer is different under different state law:
  - *Garbe Iron Works, Inc. v. Priester*, 99 Ill. 2d 84, 75 Ill. Dec. 428, 457 N.E.2d 422 (1983). Under Illinois law, both the owner and the contractor are necessary parties to a lien foreclosure.

# Mechanics Lien and Bankruptcy Checklist

1. Immediately stop collection efforts to avoid stay issues. Determine applicability of automatic stay to any pending litigation.
  - Is Debtor a necessary Party to the Lawsuit?
    - Stay Applicable?
  - Does Mechanics Lien Related back in time under 362(b)(3) and 546?
2. Determine time deadlines to take action under state law and under bankruptcy law.
  - 108 Tolling Applicable or Not?
  - 546(b) Statement Necessary?
    - Is filing enforcement action a necessary act for perfection?
3. Cash Collateral Issues?
4. Bar Date Issued by Court
5. Case Specific Deadlines



# Sale Issues

- Section 363 Sales
- Elements of Section 363
- Priority battles
- Sections 363(f)(3) and 363(f)(5)
  - 363(f)(3) – the interest at issue is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property
  - 363(f)(5) – the entity holding the lien could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest

# Executory Contracts in Bankruptcy

- Executory v. Non-executory contracts
- Assumption, Rejection, and Assignment of Executory Contracts
- Contracts Subject to Assumption and Assignment
- Timing
- Impact of Rejection
- Adequate Assurance of Future Performance
- Application of Section 365 of the Bankruptcy Code

# Right to Terminate a Contractor

- Construction contracts are executory
- Automatic Stay
- Motion to Lift Stay
- Termination must have been final

# Right of Contractor to Complete

- The right to complete, but not the obligation
- Contractor assumption of contract

# Claims and Causes of Action in a Bankruptcy Proceeding

- Claims against the Debtor
- Schedules and SOFAs
- Liens
- Proofs of Claim
- Distributions on account of allowed claims

# Claims Against a Debtor's Payment Bond

- Payment bonds and proceeds of payment bonds are not property of estate
- Payment bond claims against a Debtor's bond are generally not subject to automatic stay or to any other powers of a bankruptcy court

# Reclamation

- Stopping goods in transit
- Reclamation

# Setoff and Recoupment

- The right of setoff “allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the ‘absurdity of making A pay B when B owes A.’” *Citizens Bank v. Strumpf*, 516 U.S. 16, 18, 116 S.Ct. 286 (1995)
- Bankruptcy Code does not create right of setoff, thus key is language in agreements or state law
- Two Steps
  - One does independent right exist outside of bankruptcy
  - Two does claimant satisfy 11 USC 553



# Requirements of Section 553

- Both debts must be mutual
  - Same parties
  - In the same capacity (not fiduciary, etc.)
- Both must arise before commencement of the bankruptcy case
  - Contract debts determined when entered into even if contingent or unliquidated
- Debts must both be valid and enforceable
- Stay Relief required to offset

# Recoupment

- “Recoupment” is an equitable doctrine in bankruptcy that allows one party to a transaction to withhold funds due another party where the debts arise out of the same transaction.
- Recoupment does not require compliance with the elements of Section 553 of the Bankruptcy Code
- Most courts hold that recoupment does not require stay relief

# Recoupment

- The fact that the transactions were from the same contract is not alone sufficient to establish recoupment, and a creditor must establish equitable circumstances showing it would be inequitable for the Debtor to retain the benefits of a contract
- Can be used pre- and post petition
- Recoupment is a defense – it cannot be used to get money from the debtor

# Setoff vs. Recoupment

- Setoff involves multiple contracts
- Recoupment involves one integrated transaction
- Example –
  - Seven separate construction jobs – offsetting between those jobs
  - Recoupment applies only to one job

# Preference Actions

Just when you think bankruptcy could not get any worse:

- Remember that payment you got two weeks before the Debtor filed after weeks of calling and yelling and threatening . . .  
Yeah . . . you may have to repay that...
- Debtor's money or property transferred within 90 days before filing may be clawed back
  - No intent required

# Five (Six) Elements of a Preference Action

- 11 USC 547(b) provides that the trustee may avoid (set aside) transfers of the debtor's interest in property:
  - 1) to or for the benefit of a creditor;
  - 2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
  - 3) made while the debtor was insolvent;
  - 4) made –
    - (a) on or within 90 days before the date the petition was filed; or
    - (b) if the creditor was an insider, on or within one year before the date the petition was filed; and
  - 5) that enabled the creditor to receive more than the creditor would have received if–
    - (a) the case were a case under chapter 7 of the Bankruptcy Code;
    - (b) the transfer had not been made; and
    - (c) the creditor received payment of such debt to the extent provided by the provisions of chapter 7.

# Transfer of Debtor's Property

- Must be Debtor's property that was transferred
- Earmarking Defense – third party provides funds to debtor to pay off existing creditor and not have control of the funds, thus not their property
  - *In re Entringer Bakeries, Inc.*, 548 F.3d 344 (5<sup>th</sup> Cir. 2008)
- Constructive Trust - when a subcontractor holds the joint check solely in constructive trust for a sub-subcontractor, the joint check does not constitute property of the estate. *Mid-Atlantic Supply, Inc. of Va. v. Three Rivers Aluminum Co. (In re Mid-Atlantic Supply Co.)*, 790 F.2d 1121, 1126-28 (4th Cir. 1986)

# Joint Checks?

- Depends on the Parties and their Obligations
  - In a bankruptcy case filed by a subcontractor – a joint check issued by a general contractor to the sub-contractor and their sub-contractor can be a preference - *Guttman v. Impulse NC, Inc. (In re Railworks Corp.)*, 387 B.R. 156, 164 (Bankr. D. Md. 2008)
  - Where a contractor issued a joint check to a materialman and an insolvent subcontractor, no preference resulted since the general contractor had an independent contractual obligation to pay the materialman under the agreement. *In re Flooring Concepts, Inc.*, 37 Bankr. 957 (9th Cir. BAP 1984)
  - Best Practice – Get a Joint Check Agreement that states insolvent party has no right to the funds other than to pay the particular creditor



# Property of the Debtor Continued

- State Law as Effecting Property of the Debtor
  - Some state statutes or case law provide that certain payments made in construction cases are made in statutory or common law trusts and therefore are not property of the Debtor
  - *Begier v. IRS*, 496 U.S. 53, 58 (1990) – if the Debtor’s estate is not diminished by the transfer because the debtor did not have an equitable interest in the property, the property is not recoverable.

# Creditor/Antecedent Debt Elements

- Creditor – 11 USC 101(10) – general an entity that has a pre-petition claim against the Debtor
- Antecedent Debt – Debt must be pre-existing before payment or transfer received
  - a debt is incurred, for purposes of 11 U.S.C. § 547(b)(2), when it arises and not when payment becomes due. *In re Futoran*, 76 F.3d 265, 267 (9th Cir.1996); *Intercontinental Publications, Inc. v. Perry (In re Intercontinental Publications, Inc.)*, 131 B.R. 544, 549 (Bankr.D.Conn.1991)

# Insolvency and 90-day requirement

- Insolvency presumed for 90 days before filing, but can be rebutted – 11 USC 547(f)
- Transfer must be within 90 days for a third party or 1 year for an insider
  - Note presumption of insolvency does not extend past 90<sup>th</sup> day so Plaintiff must prove insolvency for longer period

# Chapter 7/Liquidation Element

- Essentially – would a creditor have gotten the same or more in a Chapter 7 liquidation if no preferential transfer had occurred?
  - Secured creditor secured to the extent of value
  - Undersecured creditor can be the subject of a preference – *Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (In re Capital)*, 501 B.R. 549, 619 (Bankr. S.D.N.Y. 2013)
  - If defendant asserts it is oversecured, burden on the plaintiff to prove it is not – *Id.*
- Trust Fund Defense - *In re Arnold*, 908 F.2d 52 (6<sup>th</sup> Cir. 1990)(construction funds held in trust and not estate property); *In re IT Group*, 326 B.R. 270 (Bankr. D. Del. 2005)(same); *Contra, In re Sierra Steel, Inc.*, 96 B.R. 271 (BAP 9<sup>th</sup> Cir. 1989)(construction funds not trust funds).

# Defenses to Preference Actions

## Section 547(c)

- Contemporaneous Exchange for New Value – (c)(1)
- Ordinary Course - (c)(2) – Subjective and Objective
- New Value – (c)(4)
- Statutory Lien - (c)(6)

# Contemporaneous Exchange

- Two requirements: (1) intent by debtor and creditor to be a contemporaneous exchange for new value; and (2) was substantially contemporaneous
  - New Value – 547(a)(2) – money, moneys worth in goods, services, or new credit or release by a transferee of property previously transferred . . . Does not include obligation substituted for existing obligation
    - Payments made on account of an antecedent debt are not substantially contemporaneous – *In re Pameco Corp.*, 356 B.R. 327 (Bankr. S.D.N.Y. 2006)
  - Issue – Does release of a mechanics lien constitute new value in exchange for payment? –
    - Maybe – but most courts say no based on definition of new value

# Ordinary Course

- Subjective – dealings between the parties – timing of payments, collection efforts, demands, methods of payment, change in terms, etc.
  - *In re Cocolat, Inc.*, 176 B.R. 540 (Bankr. N.D. Cal. 1995).
- Objective – dealings in the industry between like parties
  - Generally ruled on in a failure of proof or evidence, generally need an expert
  - *In re Tolona Pizza Products, Corp.* 3 F.3d 1029 (7<sup>th</sup> Cir. 1993)
  - *In re SGSM Acquisition Co., LLC*, 439 F.3d 240 (5<sup>th</sup> Cir. 2006)

# New Value

- 547(c)(4) – Subsequent New Value
  - Providing services or goods after receipt of a preference
  - Example:
    - 120 Day – Balance Due of \$100,000 to creditor
    - 89<sup>th</sup> Day - \$10,000 received
    - 85<sup>th</sup> Day - \$15,000 worth of goods delivered
    - 70<sup>th</sup> Day - \$10,000 received
      - Two preferences received totaling \$20K
      - New Value can only be applied to transactions before, resulting in \$10K net preference



# Statutory Lien

- Holders of inchoate statutory liens would be faced with an unreasonable Hobson's choice between accepting payment or taking the commercially unreasonable step of declining payment in order to perfect an inchoate statutory lien. Official Comm. of Unsecured Creditors of 360Networks (USA), Inc. v. AAF-McQuay, Inc., 327 B.R. 187 (Bankr. S.D.N.Y. 2005),
- 547(c)(6) and 545 essentially provide that the trustee or a debtor cannot avoid as a preferential transfer the perfection within the preference period of a true statutory lien
  - Statutory history also reflects protection for transfers in satisfaction of such liens - *Cimmaron Oil Co., Inc. v. Cameron Consultants, Inc.*, 71 B.R. 1005 (Bankr. N.D. Tex. 1987)

# Best Practices?

- Indemnity, surety, bond security from other parties before releasing
- Escrow
- Conditional Waiver not effective until 91 days after receipt with no bankruptcy
- One Court has suggested filing precautionary mechanics liens to perfect even if payment received.
  - *Precision Walls, Inc. v. Crampton*, 196 B.R. 299 (Bankr. E.D.N.C. 1996) – note danger of slander of title

# Practical Tips and Guidance

- Guaranties
- Surety Bonds

# Surety Issues in Bankruptcy

- Termination by Surety
  - Automatic Stay Issues
    - Principal is the Debtor v. some other party?
    - Termination partially complete?
    - Waiver of automatic stay?
  - Property of the Estate
  - Executory Contracts
    - Rejection, assumption, adequate protection

# Questions



# THANK YOU

Please feel free to contact us with any questions

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