Your GC/Sub Files Bankruptcy—Now What?

Central Ohio Chapter of CFMA

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What Happens When Bankruptcy is Filed?

- Estate is created, consisting of all the debtor's property—"property of the estate."
- Automatic stay goes into effect.
- Clock starts ticking for certain actions by creditors—must be vigilant to protect certain rights.

Property of the Estate

- At the time the bankruptcy is filed an "estate" is created, which is comprised of the expansive list of property "wherever located and by whomever held," which is set forth in section 541 of the Bankruptcy Code.
- Whether property is "property of the estate" has a number of implications for both the debtor and creditors, *e.g.*, whether the automatic stay applies, whether sureties and creditors can be paid from contract funds, and whether the debtor can sue to recover contract funds as a preference, or in a turnover action.

Property of the Estate—continued

- Disputes over whether property is "property of the estate" commonly arise over funds paid or that remain unpaid under a construction contract as they may be held in trust, in escrow, in retainage, may not yet be due, or may be subject to an independent obligation to pay the debtor's sub-contractors.
- Defined in section 541(a)(1) as "all legal or equitable interests of the debtor in property as of the commencement of the case."
- The debtor's interest in property is most often defined by state law, and is no greater than it exists outside of bankruptcy.

Property of the Estate—continued

- Whether unpaid funds are "property of the estate" depends on the contract terms, state law and circumstances.
- Property of the estate issues can arise in many contexts in bankruptcy, can involve litigation (adversary proceeding), and may present complex issues.
- Whether funds are estate property impacts whether suppliers and subs will recover in full or only a pro-rata percentage as an unsecured creditor, in the absence of lien, setoff or recoupment rights, and whether they will be subject to having to repay funds received before or during bankruptcy.

Property of the Estate—continued

- Analysis is a little different in the Sixth Circuit (Michigan, Ohio, Kentucky and Tennessee).
- "It has been recognized that property of the estate issues are treated differently by the Sixth Circuit in the specific context of construction cases." Pyper Constr. Co. v. Rieser, Adv. No. 05-3146 (Bankr. S.D. Ohio 2007).
- Independent obligation doctrine—court-made exception to section 541(a)(1).

Property of the Estate—continued

- Trust funds
  - Property for which the debtor has "only legal title and not an equitable interest," is not property of the estate. (§ 541(d)).
  - Whether property is held in trust depends on state law and contract terms.
  - Some states, including Michigan and Kentucky, have general builder/construction trust fund statutes, but Ohio does not.

Property of the Estate—continued

- Progress payments and retainage funds
  - To determine whether unpaid progress payments are "estate property" courts evaluate whether the contract terms have been satisfied, entitling the debtor to payment.
  - "The right to receive payment pursuant to a contract is a legal and equitable interest in property, and, thus, property of the bankruptcy estate." Ohio Farmers Ins. Co. v. Hughes-Bechtol, Inc., 249 B.R. 745 (S.D. Ohio 1998).

Property of the Estate—continued

- In determining if retainage funds are "property of the estate," courts look at whether the contract provided for the owner to retain a percentage of each progress payment to insure payment of suppliers and subs, and whether those suppliers and subs have been paid.
- Retainage may or may not be "estate property," depending on the circumstances.
- In contrast, in the absence of a retainage provision, progress payments that have been earned are likely estate property.

Property of the Estate—continued

- Payment and performance bonds
  - Bonds are generally not "estate property" and can be pursued notwithstanding bankruptcy.
- Escrow accounts
  - Similar to analysis of trusts, whether something is truly an "escrow" will be determined by the terms of state law and the agreement.
  - May arise in the context of deposits for purchase of condominiums or residence.

Property of the Estate—continued

- Joint checks
  - Another way in which property might not become "property of the estate."
  - "Earmarking doctrine" is effectively another exception to section 541(a).

Automatic Stay

- Goes into effect "automatically" when the bankruptcy petition is filed.
- Broadly prohibits actions to enforce or assert claims against both the debtor **and** "property of the estate."
- Although the stay is broad, there are a number of exceptions listed in section 362(b).

Automatic Stay

- The bankruptcy court can terminate, annul, modify or condition the stay for a number of reasons, such as: (1) a lack of "adequate protection"; and (2) if the debtor does not have an equity in the property and it is not necessary to an effective reorganization.
- Courts do not take violations of the stay lightly and can impose sanctions to deter further violations.
- In individual's bankruptcies, courts "shall" impose "actual damages, including costs and attorneys' fees, and, in appropriate circumstances, . . . punitive damages" for "willful violations." (section 362(k)).

Reclamation / Section 503(b)(9)—Act Fast!

- Reclamation
  - The Bankruptcy Code preserves reclamation rights under state law and allows creditors to exercise those rights with certain time limits.
  - Section 546(c) provides an exception from the trustee's "strong arm" and other avoidance powers for reclamation rights in bankruptcy.
  - **But,** a seller may not reclaim the goods unless it makes a written demand (a) not later than 45 days after the debtor's receipt of the goods; or (b) not later than 20 days after the bankruptcy is filed, if the 45-day period expires after the bankruptcy is filed.

Reclamation / Section 503(b)(9)—Act Fast!

- 503(b)(9) Administrative Expense Claim
  - Picks up where reclamation rights leave off; can be asserted even if the seller of goods fails to timely make a written demand for reclamation.
  - Is an "administrative expense claim" that should eventually be paid full, or close to, full value of the claim, ahead of unsecured and priority claims.
  - Only applies, however, for "the value of any goods received by the debtor within 20 days before" the bankruptcy.

Mechanics' Liens in Bankruptcy

- Perfection
  - Notwithstanding the automatic stay, can still perfect mechanics' liens in certain circumstances.
  - In order to be authorized to file a lien after the bankruptcy is filed, the lien must be retroactive to a date prior to the bankruptcy.
  - In Ohio, mechanics' liens can be perfected against the debtor's property after the bankruptcy is filed, presuming it is not a public project.

Mechanics' Liens in Bankruptcy

- Continuation of Perfection
  - If applicable (non-bankruptcy) law requires that an action be commenced to maintain perfection, then the lien claimant must either: (a) obtain relief from the stay to file the action; or (b) give notice within the time fixed by applicable law under section 546(b)(2).
  - The type of "notice" required is not defined; courts are split on whether a proof of claim is sufficient.
  - In contrast, if further action under state or federal law is only for enforcement of the lien rights (not to maintain perfection), then section 108(c) extends that period to commence or continue that action in a court other than the bankruptcy court.

Mechanics' Liens in Bankruptcy

- Validity in Bankruptcy
  - Presuming validity under state law, mechanic's liens are not avoidable in bankruptcy because section 547(c)(6) says that a trustee may not avoid a transfer "that is the fixing of a statutory lien that is avoidable under section 545" of the Bankruptcy Code.
  - Under section 545, which governs whether statutory liens are avoidable, mechanic's liens are uniformly considered to be unavoidable statutory liens.

Mechanics' Liens in Bankruptcy

- Litigation in Bankruptcy
  - Validity, as well as priority, of mechanics' liens, mortgages and other liens may be litigated in bankruptcy.
  - At the beginning of a chapter 11, the debtor most often seeks court approval for debtor-in-possession ("DIP") financing and use of "cash collateral."
  - Often, in exchange, the bank will seek the debtor's agreement that the bank's liens are properly perfected and in first priority, and leave only a short window of time, *e.g.*, 60 days, for other lienholders to challenge the validity or priority of those liens.

Executory Contracts

- The debtor has the power, upon obtaining Bankruptcy Court approval, to assume, assume and assign, or reject unexpired leases and "executory contracts."
- "Executory Contract" is not defined in the Bankruptcy Code. Generally accepted definition:

  "the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."

Effect of Assumption or Rejection

- The debtor is vested with all contracts prior to assumption or rejection, but the contracts cannot be enforced against the debtor unless and until assumed.
- Rejection is deemed to constitute a breach that occurred immediately pre-petition, resulting in a pre-petition claim against the bankruptcy estate.
- Assumption means the debtor will continue with, or may assign, the contract. The debtor must promptly cure any existing defaults and must provide "adequate assurance of future performance" under the contract

Effect of Assumption or Rejection - continued

- Cure requirement does not apply to defaults of any bankruptcy, solvency or financial condition provisions of a contract.
- If assuming, the debtor must assume all of the terms of the contract, and cannot pick and choose portions of a contract to assume.
- If the debtor defaults on an assumed contract while still in bankruptcy, the default generally creates an "administrative" claim which is entitled to priority treatment and payment in full on or before the effective date of a plan of reorganization.

Effect of Assumption or Rejection - continued

- Generally, a Chapter 11 debtor may wait until confirmation of its plan of reorganization to assume or reject an executory contract or lease of residential real property or personal property.
- In Chapter 7, it is a 60-day period, after which, the contract or lease is deemed rejected. Rules for commercial leases differ.
- On request of any party to a contract or residential real property or personal property lease, the bankruptcy court may order the debtor to determine whether to assume or reject within a specified period of time.

Effect of Assumption or Rejection - continued

- Contracts and leases that have been assumed may be assigned by the debtor, regardless of any contract terms providing for termination upon assignment, but the debtor must provide "adequate assurance of future performance" by the proposed assignee.
- Negotiation of cure and assignment provisions are a big part of most asset sales under section 363 of the Bankruptcy Code.

Loans and Financing

- The debtor may not assume or assign any executory contract to make a loan or extend debt financing or financial accommodations to the debtor.

Setoff and Recoupment

- Setoff permits parties that owe each other debts to apply those mutual debts against each other, avoiding the necessity of the parties actually having to pay one another. The right to set off two debts against one another is governed by state law.
- A right of setoff that exists under state law survives the filing of bankruptcy by either party.
- Setoff requires "mutuality"—that there be debts mutually owning between the two parties.

Setoff and Recoupment – continued

- Both debts must have arisen pre-petition in order for setoff to be available in a bankruptcy.
- The automatic stay of Bankruptcy Code Section 362, however, continues to be in effect with respect to a right of setoff, and the creditor must obtain bankruptcy court authority to effect a setoff through a motion for relief from stay.

Setoff and Recoupment – continued

- If the creditor's right of setoff arose within the 90-day preference period, the debtor may be able to avoid the creditor's ability to set off mutual debts as a preference.
- Unlike setoff, recoupment applies to extinguish mutual claims if the claims arise from the same transaction.
- Recoupment may be used regardless of whether the mutual claims arose pre- or post-petition.

Setoff and Recoupment – continued

- In general, a single construction project is considered to constitute a single transaction.
- When an owner's contractor, or a contractor's subtrade, files bankruptcy, the debtor or trustee will seek turnover or payment of funds that may be due under the debtor's contract or subcontract. However, the debtor's subs often file liens giving the owner or contractor the contractual or statutory right to pay those liens and set off or recoup the amounts paid against the amount claimed by the debtor or the trustee.

Setoff and Recoupment – continued

- Bankruptcy courts have held that the entity employing the debtor may pay lien or bond claims asserted by the debtor's subtrades and reduce its liability to the debtor by the amount of such payments. Courts have approved this application of recoupment without requiring prior relief from the automatic stay.

Preferences—What do you mean I have to pay it back?

- Payments and other transfers of property by the debtor within 90 days prior to the bankruptcy can be "avoided" and recovered, but there are defenses.
- The first line of defense—an issue often litigated in construction cases—is whether the property transferred was of "an interest of the debtor in property," or, in simpler terms, property of the debtor.

Preferences—continued

- A similar defense is the "earmarking" doctrine.
- Applies when money is paid by a third party to the debtor's creditor, even though it may have passed through the debtor's hands, because it was never legally within the debtor's control.
- Can apply to a payment by joint check or, potentially, direct payment by owner or GC to debtor's subcontractor.

Preferences—continued

- Other defenses
  - Numerous defenses to both the debtor/trustees' *prima facie* case—elements under section 547(b), such as by being fully secured, or under the statutory defenses in section 547(c).
  - Some examples of the statutory defenses, likely to apply in construction cases, are the "contemporaneous exchange for new value" defense (section 547(c)(1) and the "ordinary course of business" defense (section 547(c)(2)).
  - Could also be a "subsequent new value" defense (section 547(c)(4)).

Preferences—continued

- Mechanic's lien or "secured payments" defense
  - Can apply to both mechanic's lien claimants and other secured creditors. (Section 547(b)(5)).
  - Applies when payment prior to the bankruptcy did not enable the creditor to receive more than if they had not received the payment from the debtor and the debtor's assets were liquidated and distributed.
  - If the claim is not fully secured *(e.g.,* the amount owed equals or exceeds the value of the property), then this defense is not available.

Preferences—continued

- Contemporaneous exchange for new value:
  - This defense is often claimed when a sub/supplier has received payment in exchange for a lien waiver—to forbear from filing a lien—or in exchange for the release of a lien.
  - The courts have come to mixed conclusions on whether the waiver of lien rights qualifies as "new value" and whether the waiver of liens rights against property not owned by the debtor can constitute "new value" to the debtor.
  - Waiver of perfected lien rights, however, are often considered to be "new value," as long as the property is owned by the debtor, or the release facilitated a payment to the debtor by the owner of the property.

Preferences—continued

- Ordinary course of business defense
  - Requires a peculiarly fact-intensive analysis by the court of the facts established by the parties, such that it is often not resolvable on summary judgment; thus, must go to trial.
  - Although there are stated elements for this defense, it often defies a hard and fast legal test.
  - As one judge wrote, it is sort of like the Supreme Court's test for pornography, the court "knows it when it sees it." *See* McGranahan v. Fisher Nut Co., 360 B.R. 676 (Bankr. E.D. Cal. 2007), *citing* Jacobellis v. Ohio, 378 U.S. 184, 197 (1964).

Preferences—continued

- Subsequent new value defense
  - Generally applicable if creditor provided unsecured "new value" to or for the benefit of the debtor, after the creditor received the transfer subject to avoidance as a preference.
  - Typically applies to a running account.
  - New value can only be used to reduce prior transfers, not future transfers—not as simple as netting out the preferences and new value.
  - Mostly a mathematical computation, but there are certain court-made rules on how it is calculated, which can vary slightly by jurisdiction.

Non-Dischargeability

- In the bankruptcy of an individual, such as the owner of a GC or sub-contractor, could be a basis to object to discharge of the debt.
- Does not apply in the bankruptcy of a corporation or partnership.
- False representations concerning payments to sub-contractors have been held to be actionable under section 523(a)(2)(A). Dancor Construction v. Haskell (In re Haskell), 475 B.R. 911 (Bankr. C.D. Ill. 2012).

Non-Dischargeability

- *E.g.*, could apply to a false representation by a principal of the subcontractor to the GC, in lien waivers, that all subs had been paid in full, so that the subcontractor could receive payment.
- Another *e.g.*, could apply to the construction company's sole shareholder who signs an indemnity agreement with a surety that creates an express trust under state law, if the shareholder then fails to ensure funds are use to pay labor and materialmen.

Prior to Bankruptcy – Minimizing Risks

- When you as the prime or general contractor have a subcontractor who is in serious financial trouble but has not filed bankruptcy, and the troubled subcontractor is a key player in your timely completion of a project, you may want to support the sub financially. However, there are risks, some of which can be minimized.

Prior to Bankruptcy – Minimizing Risks – continued

- If you advance funds to the troubled sub, do so for specific purposes, such as payroll, and use a separate account established in the joint names of you and the troubled sub – don't deposit your funds into the general account of the sub.
- Insist that advances to fund payroll include provision for actual deposit of all required trust fund payroll taxes.

Prior to Bankruptcy – Minimizing Risks – continued

- To the extent your advances are specifically allocated or earmarked for payment of specific items you can argue, if the sub then is placed in bankruptcy, that the funds you have advanced are not property of the now bankrupt sub's estate, but instead, are funds for the benefit of a specific creditor or creditors.

Prior to Bankruptcy – Minimizing Risks – continued

- Try to maintain offsetting balances. For example, if you make a $10,000 advance to the sub, see that it is matched by $10,000 or more which you hold from payments received on the project from the owner/lender and which are attributable to the work or materials provided by the troubled sub.
- If you maintain offsetting funds, you enhance the ability to setoff if there is a subsequent bankruptcy.

Prior to Bankruptcy – Minimizing Risks – continued

- Be sure to paper up the transaction – keep detailed records.
- Get lien waiver releases for each advance you make.
- If you are being paid by an entity you believe to be headed for bankruptcy, think about defenses to any preference recovery action you may face later.
- Rule of thumb is to accept payments that could be preferential.

Thank You

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