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**Nothing Like a Bankruptcy Case to Torpedo
Your Construction Contract Claims...**

**What Construction Lawyers and Their Clients
Need to Know**

Presented By:

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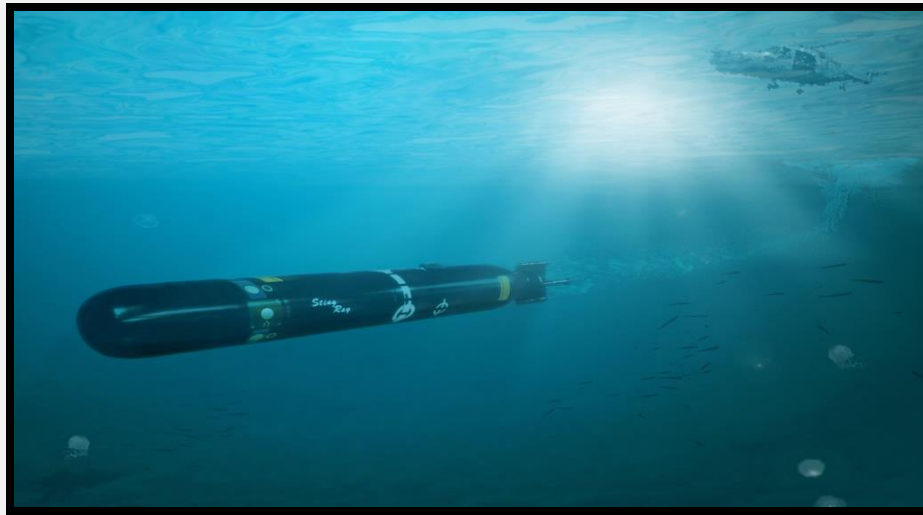
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Welcome...We will begin shortly!

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Nothing Like a Bankruptcy Case to Torpedo Your Construction Contract Claims



What Construction Lawyers and Their Clients Need to Know

- I. Who's Your Debtor?**
- II. Automatic Stay Issues**
- III. Assumption or Rejection of Construction Contracts**
- IV. Mechanics Lien Claims**
- V. Reclamation Claims**
- VI. Preference Claims**

I. Who's Your Debtor?

- A. The Owner as Debtor
- B. The General Contractor as Debtor
- C. The Subcontractor as Debtor

The Owner as Debtor

The Driving Force...



Lender

Delay → Loan Extensions → Lender Insecurity

PETITION

The Owner as Debtor

A. Primary Concerns:

1. Use of Cash—“Cash Collateral”
2. Further Financing—“DIP Financing”

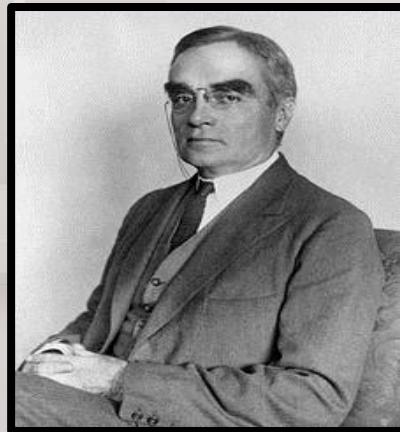
The Owner as Debtor

1. Cash Collateral (§ 363[a])
 - a. What is it?
 - b. Why is it important?
 - c. Can the Debtor use it?
 - d. Adequate Protection

The Owner as Debtor

1. Cash Collateral (§ 363[a])
 - d. Adequate Protection:
 - (i) Cash
 - (ii) Replacement Lien
 - (iii) “Indubitable Equivalence”

Hon. Learned Hand
In re Murel Holding Corp., 75 F.2d 941 (2d Cir. 1935)



The Owner as Debtor

1. Cash Collateral (§ 363[a]):

e. Lender Overreach

(i) Cross-collateralization of Pre-Petition Debt with Post-Petition Assets.

(ii) Liens on Avoidance Actions.

For more examples, see Stripp, Stephen A., Balancing of Interests in Order Authorizing the Use of Cash Collateral in Chapter 11, 21 SETON HALL L.R. 562 (1991)

The Owner as Debtor

2. “DIP” Financing

a. Priming Liens



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- ### b. Does the Priming Lien decrease the value of your lien claimant’s secured claim and are they therefore entitled to adequate protection?

The GC as Debtor

B. Primary Concern: Construction Contracts

1. The Debtor has the Right to Assume or Reject Executory Construction Contracts Under § 365(c).
 - a. The GC as Client/Debtor has incentive to avoid pre-petition default
 - b. The Owner as Client/Non-Debtor has incentive to declare pre-petition default.

The GC as Debtor

- b. The Owner as Client/Non-Debtor has incentive to declare pre-petition default.
 - (i) Ipso facto clauses invalid (§ 365[e][1]).
 - (ii) “De facto ipso facto”.
In re Ernie Haire Ford, Inc., 403 B.R. 750 (Bankr. M.D. Fla. 2009)
 - (iii) Valid pre-petition termination should be **performance-based**.

What Do You “Need to Know?”

1. Avoid pre-petition default if you are a contractor faced with potential insolvency. If you are in default by the time you get to your bankruptcy lawyer, it may be too late.
2. Consider pre-petition default you are an owner faced with potential contractor-insolvency. Are you better off terminating and completing with a new contractor (avoiding further delay); or, participating in the bankruptcy case?
3. Don't negotiate for unenforceable ipso facto clauses. If you seek to default a contracting party, make it performance-based.
4. Protect your lien position from cash collateral attacks and DIP lenders.

II. The Automatic Stay

AUTOMATIC STAY CONSIDERATIONS – SECTION 362 OF THE BANKRUPTCY CODE

The typical fact pattern - someone in the chain of contract has filed bankruptcy and you are not getting paid. Can I still file my lien?

Relevant Bankruptcy Code Sections

11 U.S.C. §362 – Ordinarily is seen as a **BIG RED STOP SIGN** Normally prohibits creditors from taking any action to collect money from debtors in bankruptcy. The automatic stay provision of the Bankruptcy Code operates to stay “any act to create, perfect, or enforce any lien against property of the estate.” 11 U.S.C. § 362(a)(4).



Relevant Bankruptcy Code Sections

11 U.S.C. §362(b)(3) provides an exception to the automatic stay for any actions to perfect an interest in property where that interest will take priority pursuant to 11 U.S.C. § 546(b)(1) over the trustee's strong arm powers (i.e., status as a judicial lien creditor with respect to personal property and status as a bona fide purchaser for value with respect to real property) as of the date of the bankruptcy petition.

Relevant Bankruptcy Code Sections

Therefore, reading the two statutes together, to the extent:

(1) that the interest exists as of the petition date; and
(2) that (a) the perfection of the interest will relate back to a pre-petition date (usually commencement of work); or (b) the perfected interest will take priority over the trustee's strong arm powers as of the petition date, 11 U.S.C. §362 does not prohibit a contractor, subcontractor, or materialman from perfecting its lien post-petition. If the lien would relate back to a point in time prior to the filing of the petition, a pure statutory analysis would indicate that the automatic stay would not prohibit filing a lien to protect its interests after a bankruptcy petition has been filed.

Cases

Some caselaw would even suggest that the automatic stay would not apply even if the lien claim would not relate back to a date prior to the bankruptcy petition was filed. see *Ivester v. Miller*, 398 B.R. 408 (Bankr. M.D.N.C. 2008); see also, *In re AR Accessories Group, Inc.*, 345 F.3d 454, 458 (7th Cir. 2003) (“statute need not contain language expressly providing for retroactive perfection in order to trigger the exception provided in 11 U.S.C. § 546(b)(1)(A)”); *In re 229 Main St. Ltd. P’ship*, 262 F.3d 1, 12 (1st Cir. 2001) (“[T]here is no requirement that the ‘generally applicable law’ referenced in section 546(b) contain an explicit relation-back mechanism.”); *In re Lionel Corp.*, 29 F.3d 88, 93 (2d Cir. 1994) (“We see nothing in § 546(b) indicating that it applies only when the lienor fits within a ‘relation-back’ statute. As long as an ‘applicable law’ authorizes perfection after another party has acquired interest to the property, a lienor fits within the exception.”); see also *Maryland Nat’l Bank v. Mayor of Baltimore (In re Maryland Glass Corp.)*, 723 F.2d 1138, 1141-1142 (4th Cir. 1983).

Recent Experience in North Carolina

In 2009 the USBC-EDNC held in a series of cases that the pos-petition filing of a claim of lien violated the automatic stay. See *In re Shearin Family Investments, LLC*, No. 08-07082-8-JRL, 2009 WL 1076818 (Bankr. E.D.N.C. Apr. 17, 2009) *In re Harrelson Utilities, Inc.*, Case No.: 09-02815-8-ATS; *In re Mammoth Grading, Inc.*, Case No.: 09-01286-8-ATS

Recent Experience in North Carolina

Rulings were made even though North Carolina has a statute that says that a lien claim relates back in time to the lien claimant's first day of furnishing of labor or materials to the project. See N.C.G.S. §§44A-10;

Recent Experience in North Carolina

The rulings were appealed. The United States District Court for the Eastern District of North Carolina, while not ruling on the merits of the appeal, questioned whether the rulings would pass constitutional muster under the North Carolina Constitution. *see Ferguson Enterprises, Inc. et al vs. Financial Federal Credit, Inc. and Mammoth Grading, Inc.* No. 5:10-cv-00316-H (USDC – EDNC 2010).

Recent Experience in North Carolina

In the aftermath of the above rulings, the North Carolina General Assembly amended N.C.G. S. §44A-18 to make clear that a mechanics lien in North Carolina was an “interest” in real property as contemplated by the meaning of that term in 11 U.S.C. §362(b)(3) and 11 U.S.C. § 546(b)

III. Assumption or Rejection of Ks

A. The DIP has the right to assume or reject an executory construction contract (§§ 365 and 1104) except in certain circumstances.



III. Assumption or Rejection of Ks

1. Is it “assumable”?
 - a. True “Executory” Contracts.
 - b. Pre-petition Termination.
 - c. Non-Delegable Contracts (§ 365[c][1]).
 - d. Contracts for Financing (§ 365[c][2]).

III. Assumption or Rejection of Ks

2. So, your contract is being assumed...what are your rights?
 - a. If there has been a default, “cure and assure”.
In re Legacy Health Care, LLC, 05-11270 K, 2006 WL 2728632 (Bankr. W.D.N.Y. 2006)
3. So, your contract is being rejected...what are your rights?
 - a. Administrative Expense Claim for Post-Petition Expenses (§ 503[b][1][A]).

What Do You “Need to Know?”

1. If insolvency looks likely, determine whether you want to preserve the contract despite the bankruptcy – preferably pre-petition.
2. If there are valid reasons for pre-petition default, terminate.
3. If a petition is filed, is the contract truly executory? Is it non-delegable?
4. If a petition is filed, you have standing to force the issue.

IV. Mechanics Lien Claims

Don't throw your hands up when there is a bankruptcy filing.

Filing and perfecting your mechanics lien or payment bond claim can mean the difference in being treated as a secured creditor and thereby realizing a substantial recovery on your claim and being treated as an unsecured creditor with little to no distribution on your claim.

IV. Mechanics Lien Claims

File your proof of claim prior to the bar date;

If the Debtor is going to seek to assume the construction contract, insist that you be paid as part of any order allowing assumption of the contract. In order to assume a contract under §365 of the Code, all pre-petition defaults must be cured. Presumably, the Debtor's failure to pay is a default under its contract, as is your mechanics lien claim or payment bond claim, and therefore it must be cured in order to assume the contract.

V. Reclamation Claims

A. Concern for Suppliers and Materialmen.

B. § 546(c) Reclamation Demand.

C. § 503(b)(9) Administrative Expense Claim.

V. Reclamation Claims

B. § 546(c) Reclamation Demand

1. Goods received in the 45 days pre-petition.
2. Demand Requirement.
3. Does this have **value** in light of potential lender secured claims?

V. Reclamation Claims

C. § 503(b)(9) Request for Administrative Expense.

1. Goods received in the 20 days pre-petition.
2. Administrative expense claims must be paid in full.
3. Expense claimant **and** preference transferee?

What Do You “Need to Know?”

1. Be aware of 546 demand time limitations!
2. Does the lender have a floating lien on your goods?

VI. Preference Claims

Preference Claims against Subcontractors and Contractors

What do you mean I have to give the money back – if I had not been paid I would have filed a lien claim or a payment bond claim???

Relevant Code Section – 11 U.S.C. 547 (b)

Preferences. A preference is any transfer of an interest of the debtor 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 ninety days before the date of the filing of the petition; or
 - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
- (5) that enables such creditor to receive more than such creditor would receive if—
 - (A) the case were a case under Chapter 7 of this title;
 - (B) the transfer had not been made; and
 - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Relevant Code Section – 11 U.S.C. 547 (b)

If you are tagged with a preference claim, the debtor or Trustee has the burden of proving each of the above elements. Assuming they can prove them, there are some exceptions that the creditor can assert:

Exception: Contemporaneous Exchange for New Value. -11 U.S.C. § 547(c)(1).

Payment by a contractor to its subcontractors may be deemed “new value” in that the subcontractor gave up its right to assert a lien or payment bond claim against the project – see *O’Rourke v. Coral Constr., Inc. (In re E.R. Fegert, Inc.)*, 88 B.R. 258 (B.A.P. 9th Cir. 1988), *aff’d*, 887 F.2d 955 (9th Cir. 1989)

However, other courts take a much more narrow view of this defense – see *United Rentals v. Angell*, 592 F.3d 525, 530 (4th Cir. 2010), *cert. denied*, 131 S. Ct. 121 (2010); *Callaway v. Kiddco*, 2010 U.S. Dist. LEXIS 144571 (E.D.N.C. Mar. 16, 2010), *aff’d*, 410 Fed. Appx. 682 (4th Cir. 2011)

Relevant Code Section – 11 U.S.C. 547 (b)

Exception: Ordinary Course of Business - 11 U.S.C. § 547(c)(2)

Creditor need only show that the transfer meets either the objective standard of the industry as a whole or the subjective dealings between the parties to qualify for this defense

Relevant Code Section – 11 U.S.C. 547 (b)

Exception: New Value - 11 U.S.C. § 547(c)(4)

Providing additional credit or services to the debtor **after** the alleged preferential payment is received will provide the creditor with an offset against the preference claim

Relevant Code Section – 11 U.S.C. 547 (b)

Exception: Fixing of Statutory Lien. 11 U.S.C. § 547(c)(6)

A trustee may not avoid as a preference a transfer that is the fixing of a statutory lien that is not avoidable under 11 U.S.C. § 545.

See discussion in slides above relative to exceptions to automatic stay.

CONCLUSION

Feel free to call with questions...

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