American Bar Association

Forum on Construction Law

When Construction and Bankruptcy Converge

George W. Kuney
The University of Tennessee College of Law
Knoxville, Tennessee

&

David J. Theising
Harrison & Moberly, LLP
Indianapolis, Indiana

Presented at the 2018 Annual Program
April 12-14, 2018
The Roosevelt New Orleans
New Orleans, Louisiana

©2018 American Bar Association
Understanding the impact of bankruptcy in the construction industry can help address the associated challenges and potentially allow parties to proactively avoid problems from the outset. The goal is to understand substantive and procedural rights and remedies to minimize problems and maximize recovery in bankruptcy.

I. Bankruptcy Fundamentals – Key Concepts

A. Different Chapters of the Code

Depending on a particular debtor’s circumstances, a voluntary petition may be filed under one of various chapters of Title 11 of the United States Code (the “Bankruptcy Code” or “Code”), the most common of which are Chapters 7, 11, and 13. An involuntary petition may only be filed under Chapters 7 or 11.

Most individuals file bankruptcy under either Chapter 7 or Chapter 13 of the Code. Under Chapter 7, a trustee is appointed to investigate the financial affairs of the debtor and to liquidate any non-exempt assets (including the pursuit of litigation claims) in order to make a distribution to creditors. Under Chapter 13, the debtor repays some portion of his debts to his creditors under a repayment plan that is administered over a period of 36 to 60 months by a Chapter 13 trustee. Individuals whose debt levels exceed the Chapter 13 allowed caps can file a Chapter 11 case.

Businesses (including corporations, partnerships, limited liability companies, and other types of business entities) file bankruptcy under Chapter 7 or Chapter 11 of the Code. A Chapter 7 case is filed by a business that no longer intends to operate but rather chooses to permit a Chapter 7 trustee to liquidate its assets. Chapter 11, on the other hand, is the chapter of the Code used by businesses seeking to remain in possession of their assets and to either reorganize their financial affairs or conduct an orderly liquidation of their assets with management remaining in control.
(although, in appropriate cases, usually involving bad acts or incompetence, management can be replaced by a Chapter 11 trustee).

B. Bankruptcy Discharge

The underlying purpose of the Code is to provide debtors burdened by debt (both individuals and businesses) with a “fresh start” and to facilitate the orderly liquidation of debtors whose assets should be liquidated and the orderly reorganization of debtors whose financial affairs can be reorganized. To facilitate the fresh start, the Code employs two significant concepts: (1) the automatic stay that arises upon the filing of a bankruptcy petition, which halts, among other things, all collection actions of creditors against the debtor or property of the estate; and (2) the discharge of debts that arose before the bankruptcy filing.

C. Creation of the Bankruptcy Estate – Property of the Estate

A bankruptcy case begins when the debtor files a voluntary petition for relief or when an involuntary petition gets filed against the debtor by its creditors.\(^2\) By operation of law, an automatic stay becomes effective immediately to protect the debtor, its estate, and property of the bankruptcy estate from virtually all forms of litigation, debt collection, lien creation, and lien and judgment enforcement.\(^3\) The filing of a bankruptcy petition creates an “estate” composed of “all legal or equitable interests of the debtor in property as of the commencement of the case.”\(^4\) The “bankruptcy estate” is created by law to be administered under the protection and general supervision of the bankruptcy court.\(^5\) This estate is vested with special rights and powers, including the right to:

1. Compel third parties to pay debts owed to the debtor and return property of the estate in their possession;\(^6\)
2. Avoid certain pre-petition transfers, including preferential and fraudulent transfers,\(^7\) and recover the property or its value from the transferee;\(^8\)

3. Sell, lease, or otherwise use property of the estate, even if the property is encumbered by valid pre-petition liens or are subject to adverse claims by third parties;\(^9\) and

4. Cure defaults under, and reinstate the terms of, unexpired leases and executory contracts, notwithstanding defaults and provisions in those agreements that otherwise would permit termination because of the debtor’s bankruptcy or insolvency.\(^10\)

The date when a bankruptcy petition is filed is legally significant. All claims and obligations that arose pre-petition, whether liquidated or unliquidated, fixed or contingent, disputed or undisputed, are thereafter treated as claims against the bankruptcy estate. Unsecured claims will generally cease bearing interest. Secured claims that might otherwise be entitled to interest can be “valued” by determining the value of the collateral as of the petition date. In other words, the claim will be secured to the extent of the value of the collateral securing it. If that collateral is worth less than the amount of the claim, the creditor will only have a secured claim to the extent of the value (and will not be entitled to interest on that secured claim) and will have an unsecured claim for the deficiency.\(^11\) If the value of the collateral exceeds the amount of the debt, the creditor will be entitled to interest, fees, and costs, to the extent permitted by contract or applicable law.\(^12\)

All claims that arise subsequent to the petition date are entitled to administrative expense status and have a higher priority than general unsecured pre-petition claims.\(^13\) The purpose of this higher priority is to encourage parties to do business with the debtor and facilitate its reorganization.
D. Trustees, Debtors-in-Possession, and Committees

In the mass of ordinary bankruptcies (particularly Chapter 7 cases), the case is administered by a trustee. The trustees are selected in rotating order from a “panel” of local trustees—typically lawyers, but sometimes accountants or other financial professionals. The trustee collects and liquidates the debtor’s nonexempt assets (although in most Chapter 7 cases there are not any). He is generally empowered to “police” the case. Sometimes, the trustee hires lawyers to represent him.

In Chapter 13 cases, in which an individual proposes a plan to repay at least a portion of his debts over, normally, a three to five year period, the standing Chapter 13 trustee for the district will collect and administer payments under the plan as well as participate in the administration of the case. The standing Chapter 13 trustee is different than the “panel” trustees who handle Chapter 7 cases.

Chapter 11 is different. There is no trustee unless the judge orders the appointment of one. In lieu of a trustee, the debtor remains in control of its business and assets as debtor-in-possession (the “DIP”). The DIP has most of the powers and responsibilities of a trustee. In the typical case, it is the debtor who initiates the bankruptcy case through its (pre-bankruptcy) lawyer. Once it has filed, the debtor—now DIP—seeks court approval to retain its lawyer as counsel for the DIP. The DIP’s counsel becomes a kind of “point person” in the Chapter 11 case.

Because the DIP has the powers of a trustee, there are many instances where a particular power will belong either to the trustee or to the DIP, depending on who is in charge. To simplify matters, in these materials we will use “DIP” to refer to the entity in charge of the Chapter 11 estate.
Do not confuse these “case” trustees with the “United States Trustee.” The U.S. Trustee for any given “region” is the head of the Office of the U.S. Trustee (the “UST”) for that region. The UST is a division of the Department of Justice that is charged with oversight of the bankruptcy system. The U.S. Trustee appoints and supervises panel trustees, appoints official committees (see below), reviews and comments on applications to employ and compensate professionals, investigates bankruptcy fraud and abuse, and can be heard on any other issue in a bankruptcy case. The U.S. Trustee is often active in the very early stages of a Chapter 11 case, although once the case is up and running, and particularly if there is active creditor participation, the U.S. Trustee generally backs off a bit. In two states (Alabama and North Carolina), there is a Bankruptcy Administrator rather than a U.S. Trustee, but the duties are essentially the same.

As noted above, a debtor filing a Chapter 11 case will remain in possession of its property and manage its business affairs as the DIP, with all the powers of a bankruptcy trustee.\textsuperscript{14} The salaries of the debtor’s officers, however, may be subject to review. Moreover, the debtor and its officers are fiduciaries bound to act in the interests of the bankruptcy estate. Under certain circumstances, “including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case,” the debtor’s management may be ousted by the court in favor of a trustee.

It is possible that a committee will be appointed consisting of representatives of general unsecured creditors.\textsuperscript{15} Sometimes in very large cases, more than one committee is appointed. The committee has the authority to retain attorneys and accountants and to:

1. Consult with the trustee or debtor-in-possession concerning the administration of the estate;
2. Investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor’s business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan of reorganization;

3. Participate in the formulation of a plan of reorganization, advise those represented by the committee of its determination as to any plan formulated, and collect and file with the court acceptances or rejections of the plan;

4. Request the appointment of a trustee or examiner;\(^\text{16}\)

5. Perform such other services as are in the interest of those represented.

The fees and expenses of professionals retained by the debtor, a committee, a trustee, or examiner are considered expenses of administration and therefore have priority over general unsecured pre-petition claims.\(^\text{17}\)

In bankruptcy cases involving construction projects, there frequently are allegations of mismanagement and/or breach of trust by the debtor’s management. For example, when a general contractor files bankruptcy, subcontractors frequently allege that the general contractor failed to pay trust funds that were received from the project owner. Likewise, where a real estate developer files bankruptcy, lenders frequently allege that the developer has improperly commingled or otherwise failed to properly use project funds.

**E. The Automatic Stay**

A bankruptcy filing will immediately trigger an automatic stay that prohibits creditors from taking action against the debtor or the debtor’s property.\(^\text{18}\) The automatic stay is effective against all creditors regardless of notice. The stay prohibits all persons from:

1. Beginning, continuing, or employing process in a judicial, administrative, or other action or proceeding;
2. Enforcing a pre-bankruptcy judgment;

3. Acting to obtain possession of, or exercising control over, property of the estate;

4. Acting to create, perfect, or enforce a lien against property of the estate;

5. Acting to enforce a lien obtained before the judgment was filed;

6. Acting to collect, assess, or recover a pre-bankruptcy claim;

7. Exercising any right of setoff; and

8. Commencing or continuing tax core proceedings.

The automatic stay does not prevent creditors of the debtor who have rights against letters of credit, bonds, sureties, guarantors, or any person other than the debtor, from pursuing those rights.\textsuperscript{19} The bankruptcy court does, however, have authority under 11 U.S.C. §105(a) to impose an injunction against acts where the respective person is not covered by the automatic stay. The courts generally use this power sparingly and only when they find that the absence of an injunction would jeopardize the debtor’s opportunity to reorganize.\textsuperscript{20}

The automatic stay continues in effect with respect to property until that property is no longer part of the bankruptcy estate. Generally, the automatic stay remains in effect until the bankruptcy case is closed, the case is dismissed, or, in the case of an individual debtor in a Chapter 7, 11 or 13, when a discharge is granted or denied.\textsuperscript{21} On the request of a party in interest, the courts may grant relief from the automatic stay:

1. [F]or cause, including a lack of adequate protection of an interest in property of the party in interest;

2. [W]ith respect to a stay of an act against property . . . , if

   a. the debtor does not have an equity in such property; and

   b. such property is not necessary to an effective reorganization; or
3. [W]ith respect to a stay of an act against single asset real estate,²² . . . by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after [the commencement of the bankruptcy case] (or such later date as the court may determine for cause . . .)

   a. the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

   b. the debtor has commenced monthly payments to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien), which payments are in an amount equal to interest at current fair market value on the value of the creditor’s interest in the real estate.²³

There are various statutory exceptions from the automatic stay.²⁴ Of significance here is section 362(b)(3), which permits a creditor after the bankruptcy filing to perfect a lien under state law that allows the lien to relate back to a date prior to the commencement of the case.²⁵ This exception allows one with rights to a mechanic’s lien to take such steps as are necessary post-petition to perfect the lien so long as the applicable state law allows perfection to relate back to a pre-petition date.²⁶ To the extent that under applicable state law the lien is effective as of the date it is recorded, however, the lien cannot be perfected by recording after a bankruptcy filing without first obtaining bankruptcy court permission.²⁷

The automatic stay serves a dual purpose. First, the stay protects the debtor from the pressure and harassment of creditors seeking to collect or enforce their claims. The stay thus provides the debtor a “breathing spell” to focus its efforts on the reorganization of its financial affairs. Second, the stay protects creditors by preventing the assault on the debtor’s assets by
individual creditors. This promotes the bankruptcy goal of equality of distribution among the
debtor’s creditors.

The protection of the automatic stay is not normally extended to non-debtor third parties. In some instances, however, courts have extended the stay to protect guarantors and/or general partners who are involved in the day-to-day operations of the debtor or who have committed to contributing funds to assist the debtor’s reorganization. In granting this relief, courts rely on the broad language of section 105(a) of the Code, which empowers the court to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”

Courts hold that creditors have an affirmative duty to comply with the stay, and that actions taken against the debtor’s property without knowledge of the stay are void (or, at least, voidable upon request of the debtor or another party in interest). Innocent violations of the stay generally do not result in the imposition of sanctions. Knowing violation of the stay, however, may result in the imposition of a variety of sanctions, including damages or the equitable subordination of a creditor’s claim. Under section 362(h) of the Code, an individual damaged by a willful violation of the stay may recover actual damages, including costs and attorneys’ fees, and punitive damages.

Bankruptcy cases involving distressed construction projects frequently involve relief from stay litigation, as the lender is pressing to obtain immediate control over the project to liquidate its collateral through foreclosure. In such cases, the success of the bankruptcy frequently hinges on the outcome of the lender’s motion for relief from stay filed in the early stages of the bankruptcy case.

Many contracts, including construction contracts, include a default and/or termination provision that is triggered by a party’s insolvency or bankruptcy filing. For example, construction
subcontracts frequently empower the general contractor to terminate a subcontract in the event of a bankruptcy filing by a subcontractor. This type of provision, which generally is referred to as an *ipso facto* clause, is not enforceable in bankruptcy.\(^{32}\) Any post-petition attempt to terminate a contract based on an *ipso facto* clause likely will be viewed as ineffective and, further, likely will be viewed as a violation of the automatic stay.

**F. Claims and the Rules of Priority Under the Code**

Creditors in a bankruptcy case are distinguished by the type of claims they hold. The Code sets forth a priority scheme for creditors’ claims in section 507. In general, creditors whose claims are secured by assets of the estate (“secured creditors”) are in a superior position, and such claims are outside the gambit of section 507 entirely. Should a Chapter 11 debtor fail in its attempt to reorganize, a secured creditor may generally look to the liquidation of its collateral for payment of its claim (subject to many caveats, which we don’t discuss here).

Conversely, all other creditors (including undersecured creditors with a deficiency claim) are dependent upon unencumbered assets of an estate for payment. The priority for payment of these claims is generally as follows: first, spousal support obligations; second, costs of administration (including professional fees and post-petition expenses of operating the debtor’s business); followed by a host of unsecured claims that Congress has determined deserve a special high priority and, finally, general unsecured pre-petition obligations. By virtue of their last-in-line-before-equity position, general unsecured creditors might be viewed as having the most to lose should a Chapter 11 debtor’s reorganization fail. It is for this reason that unsecured creditors may be those most benefited by a thorough monitoring of the debtor’s affairs during the case.

The priority scheme in bankruptcy dictates the order in which claims are paid. Think of a ladder. The claims standing on the highest rung must be paid in full before any claims on the next
rung can be paid anything. The senior class of creditors gets paid in full, then the next class, and so forth, until you come to a class for which assets are insufficient to pay everyone in full.

What happens then? The basic principle is one of pro rata distribution among similarly situated creditors. This is supposed to supplant the “race to the courthouse” that would occur if not for the automatic stay of bankruptcy. It sounds simple and fair. But—as with many things in bankruptcy—it is less simple than it initially appears, and whether you think it is fair probably depends on what rung of the ladder you find yourself standing.

For starters, let’s make sure we understand what we mean when we talk about pro rata. It’s pretty straightforward: pro rata means that when there are not enough assets to go around, then each creditor gets a share determined by the size of his allowed claim relative to the total claims in the creditor’s class. So if there is enough to pay 20 percent of all claims in a given class, then we pay each creditor in that class 20 percent of his claim.

For example, suppose the Debtor owes $10 to the Butcher, $20 to the Baker and $30 to the Candlestick Maker—a total of $60. The Debtor has $12—just 20 percent of what he owes. Under non-bankruptcy law, assets would go first to the fastest, and others would be left empty-handed. Under the pro-rata rule of bankruptcy, since we have assets equal to 20 percent of all claims, we would pay 20 percent of each claim. So, Butcher would get $2, Baker would get $4, and Candlestick Maker would get $6. Such is the basic bankruptcy rule. But at least four facts conspire to assure it almost never works out that way.

First and most important, in many cases there are no assets to distribute to creditors. This is particularly true in Chapter 7. One hundred percent of nothing is nothing. Second, the Code itself mandates a schedule of priority claims. For now, suppose that Butcher has a priority claim, and that Baker and Candlestick Maker have non-priority claims (i.e., Butcher is on a higher rung
of the ladder). We will pay Butcher $10. That leaves $2 for distribution between Baker and Candlestick Maker, pro rata. Even where there are assets to distribute, in many cases the priority claims will eat up the assets before we ever get to the residual non-priority class.

The bankruptcy priority schedule is explicit in the statute. Interestingly, neither of the other rules (neither “pro rata” nor “secured comes first”) is spelled out in any detail. They are so basic to bankruptcy that nobody thought to say so. There are plenty of Code provisions that recognize these basic rules, at least in a backhanded way.

As if this were not enough, there are at least two other principles which complicate the distribution scheme. First, in a Chapter 11 case, the court may confirm a plan of reorganization which (within limits) can vary the off-the-rack rules of distribution. Second, the Code also provides that the judge may, in an appropriate case, “subordinate” one claim to another. Likewise, case law permits the court (under limited circumstances) to “recharacterize” debt as equity—which of course has an impact on the priority scheme.

1. Administrative Expenses

The “real” first priority is the second: section 507(a)(2) gives a second priority to “administrative expenses allowed under section 503(b).” Section 503(b)(1)(A) in turn defines “administrative expenses” as “the actual necessary costs and expenses of preserving the estate.” This is, among other things, the place where the lawyers get paid: fees for non-trustee professionals who represent the estate are administrative expenses (but all subject to court control).

And note “necessary,” italicized above. This is the stuff that litigation is made of, and some courts have found wiggle room here. The 2005 reform legislation expanded this definition’s nonexclusive list of administrative expenses to include post-petition employee pay, NLRB back-pay awards, up to two years of rent under a lease that is first assumed then rejected, the costs of
closing a healthcare facility, and the value of 20 days of pre-petition goods delivered to the debtor. This priority also encompasses post-petition taxes incurred by the estate.

Taxes

Aside from administrative expenses, probably the next most important priority is the priority for taxes. There are three quick points about the tax priority to be made. First, note that this tax priority stands only eighth on the statutory priority ladder. As a practical matter, however, the tax priority is a lot more important than several of those that precede it. Second, note that the priority applies only to unsecured tax claims. In plenty of cases, the tax collector will have a statutory tax lien—a kind of secured claim. Working out the relationship between the secured lien claim and the unsecured priority claim is a bankruptcy subspecialty all its own. Third, note that the priority applies only to tax claims—not to government claims in general. The government’s non-tax claims have no special priority under the Code, although what is and is not a tax claim is, again, something that can be fought over.

2. Employee Priorities

Two subsections of Section 507 address the claims of employees where the debtor is the employer. Subsection 507(a)(4) gives a limited priority for wage claims and subsection 507(a)(5) provides for claims under employee benefit plans. These claims are often matters of great urgency to individual employees. Indeed, a practice has developed of paying these priority claims (now up to $10,000 per employee) soon after the case has been filed. This requires court approval—and there’s nothing in the Code that specifically authorizes the court to grant such approval—but courts commonly grant the relief anyway.

In an operating Chapter 11, the employee priority claims aren’t likely to be a deal-driver. If there is an employee issue in a complex business Chapter 11 case, it is more likely to involve
the issue of employer liability under a government-guaranteed pension plan, the matter of employee rights under a collective bargaining agreement, or proposed retention incentive plans.

3. Other Priorities -- Above and Below the List

Most of the other provisions of section 507 are special-interest rules that have little or nothing to do with the ordinary case. But there are two other kinds of statutory priorities. One is the matter of priorities “above the list”—so-called “superpriorities.” The other is the matter of priorities “below the list”—residual priorities for liquidating cases under section 726.

First, superpriorities. We saw above that the first priority goes to administrative expenses. But not all administrative expenses are created equal. For example, a party who extends post-petition financing to a debtor under section 364 often negotiates for a “superpriority” that trumps other administrative claims. Also, a claim for failure of adequate protection has a super priority. On occasion you will see a court order that purports to create other “superpriorities” even though these are not provided for in the Code. This can happen, for example, with breakup fees payable to an initial proposed asset purchaser that is outbid by another in section 363 sales.

And perhaps the highest priority of all is the priority that trumps the claim of the perfected security interest. Section 506(c) permits the trustee to recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim including the payment of all ad valorem property taxes with respect to the property. Only the trustee or debtor-in-possession may assert a surcharge claim; creditors may not assert it. There are other “priorities” that have the effect of trumping secured claims. One is the “priming lien” for post-petition financing under section 364(d). Another is the “carve-out” often agreed to by secured lenders for the benefit of debtor and committee professionals.
Second, priorities “below the list.” Bankruptcy is about debtors who don’t have enough money to go around. But once in a while, you run into a solvent estate—a case where there is enough to pay all priority and general unsecured claims (maybe market prices shot up after filing). In those cases, you might think the residual would go back to the debtor or its shareholders. In Chapter 11, that is the general rule. But in a Chapter 7 liquidating case, even after all section 507 priorities are paid, money does not go to the debtor until you have paid the separate list of “liquidating priorities” in section 726, including such things as late-filed claims, punitive damages, and post-petition interest.

4. **Priority for Essential Trade Vendors**

We have mentioned a few ways that a court order can create a priority that’s not provided for in the Code. One example worthy of special note is the “critical trade vendor.” Usually these are creditors who have only general unsecured claims, but they jump to the front of the line, getting paid in full even though other claims of a similar rank will probably wait a long time for any payment, and then receive only cents on the dollar. The argument is that these “critical trade vendors” are necessary for the debtor’s survival, and they will not continue to ship to the debtor unless they are paid in full. Courts often agree with this argument, although it appears that the “critical trade vendor” argument has been somewhat aggressively overused, and that some courts are becoming more skeptical of these claims.

5. **Maybe You Own the Asset?**

One way to obtain “priority” over other creditors is to establish that you own an estate asset, so that other creditors should have no interest in it at all. One example is the “constructive trust” theory—a remedy that may be available to a creditor that was the victim of theft or similar wrongdoing. If you prevail, you may have “your asset” returned to you, rather than divided among
creditors. Another example is the “absolute assignment of rents” that has been recognized by some courts, allowing a mortgage lender “ownership” of the rents rather than a mere security interest. And a few courts have recognized “equitable liens”—this one won’t give you ownership of the asset, but it may have the same effect—an unsecured creditor may find itself fully secured.

6. Some Other Priorities Spread Throughout the Code

There are a few other sections of the Code that set forth de facto priorities. They may not be thought of as priorities, but they have the same effect. For example, section 553 permits a creditor who has a right of setoff to get paid in full (after obtaining stay relief) to the extent of his setoff right, affording priority over other creditors and essentially providing secured creditors status to the setoff creditor. A reclamation creditor may get an administrative claim or a lien that gives it priority over other unsecured creditors, under section 546(c). Then there are more obscure priorities, such as the rights of customers in a brokerage firm’s bankruptcy. Once again, the lesson is to think creatively before you resign yourself to sharing pro rata.

G. Plan of Reorganization and Disclosure Statement

The ultimate goal in a Chapter 11 bankruptcy is confirmation of a plan of reorganization. A plan is essentially an agreement between the debtor and its creditors in which the debtor’s obligations that existed prior to the commencement of the bankruptcy are extinguished and, in their place, new obligations are substituted.

Whether it provides for a reorganization or liquidation of the debtor, a plan will provide for, among other things, a proposed treatment of each class of creditor claims and a proposed means for implementation. In developer and builder cases under Chapter 11, plans typically will provide for the disposition of remaining projects (either by way of completion or by way of transition to project lenders) and for the establishment and funding of a liquidating trust to pursue
bankruptcy causes of action and to administer distributions to unsecured creditors. Also, it is common in developer and builder cases for lenders who will be involved in the completion of projects to be active in formulating and proposing plan.

A Chapter 11 debtor has the exclusive right to file a plan for a certain period of time. Once the debtor’s “exclusivity” period has expired or otherwise terminated, creditors have the right to propose their own plan. In some cases, the most drastic action a creditor can take is to propose its own plan providing for the immediate liquidation of the debtor.

1. Prearranged and Prepackaged Chapter 11 Plans, a.k.a. “Prepacks”

A prepackaged bankruptcy (or “prepack”) is a form of consensual Chapter 11 restructuring that significantly reorders the traditional reorganization process. “Prepackaging” a Chapter 11 reorganization enables a debtor to minimize the impact to its ongoing business operations by combining many of the best aspects of out-of-court workouts (cost-efficiency, speed, flexibility, and cooperation) with the binding effect and structure of a conventional bankruptcy.

Unlike a traditional Chapter 11 case, the prepackaged bankruptcy is negotiated and accepted by creditors before a proceeding is commenced in the bankruptcy court. In theory, therefore, the prepackaged bankruptcy itself can be quick (sometimes as fast as 30 to 45 days) and therefore, less costly and damaging to the restructuring company. It is particularly useful for those businesses that are very sensitive to public image, such as retailers. If they are in bankruptcy for a long time the public may become skeptical and their image may be tarnished, sometimes beyond repair. If they can get in and out quickly and without a lot of public fighting, they have a better chance to emerge unscathed.

In a prepackaged case, the debtor negotiates and drafts a plan of reorganization. It then circulates the plan with its accompanying disclosure statement and ballot to creditors. The
creditors have a period of time to review the disclosure statement and plan and vote on the plan. If the debtor receives sufficient votes to confirm the plan, it then files a bankruptcy petition, the plan, the disclosure statement, and the ballots, all at the same time. If it works most of the action is done before the company is in bankruptcy. In bankruptcy, the debtor only needs retroactive approval of the disclosure statement and confirmation of the plan.

The Code recognizes the prepackaged case. Sections 1125(g) and 341(e) allow the court to count votes on a plan that were solicited before the case was filed, so long as the acceptance does not violate other law and so long as the voting creditors had the advantage of the same sort of information they would have received before voting in Chapter 11.

In a large “public company” case, the negotiations often revolve around the bondholders. For the bondholder, an imaginative observer might ask: why not simply put a provision into the original bond agreement, providing that a plan accepted out of court will be binding on dissenters.

The answer to that question is that the law does not allow it. “Public” bond issues are governed by the Trust Indenture Act of 1939. The Trust Indenture Act specifically provides that the rights of a bondholder shall not be impaired without his consent. This provision is non-waivable. This rule, coupled with the practical inability to get all bondholders to the proverbial table (or to even know who they are) probably explains the bulk of the public company prepack action.

Should not everyone use a prepack if it is quicker and cheaper than a normal Chapter 11 case? First, the debtor needs to have the kind of case where they can make a deal with a large majority of creditors before bankruptcy. That depends in large part on the nature of their creditor constituency. If the creditor group is relatively small and the debt is fairly concentrated the debtor can potentially make a deal with the creditors and then “run it through bankruptcy.” Even if the
debtor can’t make a deal with everyone, they can get agreement from the required majority and bind dissenters. But if you have hundreds of bondholders and trade creditors, with little concentration of the debt, a prepack is not likely to be achievable.

There are some risks to a prepack. The solicitation is based on a disclosure statement that has not been blessed by the court in advance. A dissenter may come in after the fact and challenge the adequacy of the disclosure and/or the method of soliciting votes. If the court sustains the challenge, it will need to be re-solicited. This can be expensive, cause delay, and sometimes derail the whole process. It used to be that dissenters would sometimes try to derail a prepack by filing an involuntary petition during the solicitation period, forcing the debtor to “start over.” The 2005 amendments to the Code (referred to as “BAPCPA”) attempted to limit the impact of this tactic by providing in section 1125(g) that a solicitation begun prior to the bankruptcy filing may continue after the filing.

2. Partial Prepacks

There are some cases where you can solicit certain classes of creditors before filing Chapter 11 and other classes afterward. These are referred to as partial prepacks. There are several reasons you might do this. Let’s say you have a case with a large bank, a relatively small group of bondholders, and a thousand trade creditors each of which is owed a thousand dollars or so. You can probably make a deal with a majority in number and two-thirds in debt amount of the bank class and bondholder class, but it is not practical with the dispersed group of small trade creditors. So maybe you solicit the bank and bonds before bankruptcy and then file and solicit the trade in Chapter 11, after obtaining approval of the disclosure statement. It may even be that you have a better chance of quick acceptance from the trade if you can tell them that you already have a deal with the bank and the bonds (which presumably has something in it for the trades).
Securities regulation often drives this approach. If the consideration being given to creditors under the plan is securities, then ordinarily the debtor must prepare and file with the U.S. Securities & Exchange Commission a registration statement. This is a time-consuming and expensive process. Section 1145 provides an exemption for securities that are distributed under a plan of reorganization in exchange for claims or interests (or principally in exchange for claims and interests and partially in exchange for cash or other property). But the exemption does not appear to apply to pre-petition solicitations. To deal with this problem, the debtor will sometimes do pre-petition solicitation of those classes where the section 1145 exemption is not necessary (such as those classes that are not getting securities under the plan) and post-petition solicitation for those classes where the exemption is needed.

3. Pre-Arranged or Pre-Negotiated Cases

The terms “pre-arranged bankruptcy” or “pre-negotiated bankruptcy” do not have specific definitions. In its most general sense, they refer to any Chapter 11 case in which the debtor has discussed with some constituency prior to the commencement of bankruptcy some form of corporate reorganization or restructuring to be accomplished through the Chapter 11 process and has received some form of commitment (which may or may not be contractual or binding by its terms) from the constituency to support a Chapter 11 plan that accomplishes that reorganization or restructuring.

Generally, however, a pre-arranged or pre-negotiated bankruptcy refers to a reorganization or restructuring that is, prior to the commencement of bankruptcy (1) negotiated with representatives of the most significant constituencies that are expected to be impaired and whose acceptance is sought or needed for confirmation (i.e., the senior lenders, the bondholders, and principal equity security holders), (2) agreed to by those representatives (even if those
representatives, by themselves, are not sufficient in number or amount to assure acceptance of the particular classes of debt that they represent), and (3) memorialized in written agreements containing the basic terms of a plan of reorganization.

The most significant procedural difference between a pre-arranged plan and a prepackaged plan is that solicitation occurs after the bankruptcy case has been filed and after the court has approved a disclosure statement.

Sometimes, in lieu of a vote (as one would get in a pre-pack) the debtor tries to get an agreement by the creditors to support a plan that contains certain basic terms, which is sometimes referred to as a “lock-up agreement.” This is common in cases involving an outside investor, who may want to know that the creditors will support its transaction before devoting the necessary resources. While most lock-up agreements are entered into before bankruptcy, post-petition lockups have been criticized by courts, particularly in Delaware, as violating the solicitation rules of section 1125.42

II. Property of the Estate and Strategies for Elevating the Status or Priority of Creditor’s Claims Against the Bankruptcy Estate

A. Reclamation Claims

The Code provides a supplier with the right to reclaim goods received by the debtor in the ordinary course of business within forty-five days prior to the bankruptcy filing, if a written demand is filed no later than forty-five days after receipt of the goods by the debtor (or twenty days after filing if the forty-five-day period expires after the bankruptcy petition is filed).43 Of significant note, this right is subject to any prior interest of secured parties.44 Hence, if a secured lender has an all-asset or blanket lien on the debtor’s inventory, this remedy often is unavailable from a practical perspective.
As within the non-bankruptcy context, reclamation refers to the right of a seller to reclaim goods sold to a debtor while the debtor was insolvent. Section 546(c) focuses on that right in the context of a sale that took place immediately before the debtor filed for bankruptcy. In such cases, timing is a critical factor. There is a narrow window within which the seller must act to protect its rights.

The right applies to goods received by the debtor, while insolvent, within 45 days prior to the petition date—although the seller may have little interest in reclaiming goods sold within the 20 days immediately preceding the petition date, since it is likely to receive full payment for such goods under section 503(b)(9). Note that section 546(c) is not derivative of or dependent upon a state’s law, U.C.C. § 2-702 or otherwise; it represents a federal right of reclamation. This right of reclamation is subject to the rights of senior secured lenders, so it may be illusory in those cases where a lender has an under-secured floating accounts receivable/inventory lien. Some large commercial debtors will seek to streamline this process by filing a “reclamation procedures motion,” requesting that this claim substitution process occur automatically without the need to make individual requests for each reclamation claim.

B. Section 503(b)(9) Priority Administrative Claims

The Code provides for a section 503(b)(9) administrative expense claim for the value of any goods received by the debtor within twenty days prior to the bankruptcy filing, even if there was no written reclamation demand. Although the claim does not apply to services contracts, the predominante purpose test applicable to hybrid goods/services contracts in Uniform Commercial Code Article 2 cases applies in bankruptcy as well. Because this claim relates to the value of the goods it can provide an avenue of relief when reclamation is available, such as when the goods
have been disposed of by the debtor or are subject to a blanket lien. Administrative claims enjoy priority of payment over unsecured claims.

C. Executory Contracts and Unexpired Leases

Another common issue that arises in the case of a chapter 11 construction filing is that the debtor normally has outstanding contracts to complete projects or outstanding contracts with subcontractors or suppliers. Construction contracts are generally considered to be executory contracts, which means that debtors may either choose to assume the contracts or choose to reject them.\textsuperscript{47}

When a debtor wishes to assume the contracts as part of maintaining business operations, this must be done prior to confirmation of a Chapter 11 plan (assumption, even for assignment, of these contracts is rare in Chapter 7 cases).\textsuperscript{48} The other party to the contract may also request the Bankruptcy Court to order that this decision be made sooner. Although such motions are generally unsuccessful, at least early in the case, many times they are successful with respect to construction contracts, particularly if performance of the contract has been assured by a performance surety.

When assuming a contract, it becomes the debtor’s obligation to cure all defaults, and pay all damages caused by those defaults.\textsuperscript{49} The debtor must continue to perform the work as the debtor is contractually obligated to do. The debtor must also provide “adequate assurances of future performance”—that is, it must show that it can carry out the contract that it proposes to assume.\textsuperscript{50} The debtor’s decision to assume or reject any executory contract or unexpired lease is subject to court approval based on the deferential business judgment standard. If the debtor’s business judgment has been reasonably exercised, the court will approve the proposed assumption or rejection.\textsuperscript{51} If the debtor elects not to assume the contract, it is rejected\textsuperscript{52} and anyone owed payments arising from the contract will be treated as any other unsecured creditor.
Under section 365 of the Code, executory contracts (which generally are defined as contracts under which both the debtor and the non-debtor party have material unperformed obligations at the time of the bankruptcy filing) and unexpired leases may be “assumed” or “rejected” by the debtor.\(^\text{53}\) If an executory contract or unexpired lease is assumed, the debtor is required to accept all of its benefits and burdens; if an executory contract or unexpired lease is rejected, the debtor generally has no obligation to perform and, subject to certain limitations, the non-debtor party is awarded an unsecured claim in the debtor’s bankruptcy proceeding for the damages it will sustain as a result of the rejection.

The right to reject burdensome contracts and leases is a key benefit of bankruptcy to debtors. Many bankruptcy cases, including retail cases involving large numbers of real estate leases, are largely precipitated and driven by the need to restructure executory contracts and unexpired leases. Moreover, the right to reject executory contracts and unexpired leases provides the debtor with a favorable platform to negotiate significant concessions, particularly concessions to real estate leases during a down market.

In a Chapter 11 case, the debtor has until the confirmation of a plan of reorganization to decide whether to assume or reject an executory contract, unless the non-debtor party to the contract requests that the court compel the debtor to decide sooner. The debtor, however, is required to perform its post-bankruptcy obligations under the executory contract, which creates a strong incentive for the debtor to decide quickly if it wants to assume or reject the executory contract.

1. *Contract Termination and/or Work Stoppages*

The automatic stay generally operates to prohibit termination of any executory contracts to which the debtor is a party.\(^\text{54}\) A contractor therefore cannot terminate a construction contract, even
if based on non-payment or some other default by the debtor. Further, any provision in a contract indicating that the debtor’s bankruptcy filing constitutes an event of default resulting in contract termination is generally unenforceable.  

2. Assumption/Assignment of Executory Contracts

A debtor in bankruptcy has the right to assume or reject executory contracts, (i.e., contracts and leases for which performance remains due from both parties). The effect of assumption of the contract is to bind the debtor and its estate to the contract and to elevate the claim of the non-debtor party to administrative status both in terms of performance and in the event of a claim for breach. In order to assume a contract, the debtor must cure any default under the contract within a reasonable period of time and give adequate assurance of future performance. The debtor is not authorized to assume an executory contract if the contract is to make a loan or extend other debt financing or effect financial accommodations to or for the benefit of the debtor, or to issue a security of the debtor. Thus, an owner/debtor cannot force a lender to loan it money under an existing loan agreement or require a surety to provide it financial accommodations.

D. Sales/Leases of Property of the Estate – Section 363

1. Sales Free and Clear of Liens, with Liens to Attach to Proceeds

Bankruptcy courts have the authority under certain circumstances to approve the sale of all or part of a debtor’s assets free and clear of all liens, claims, encumbrances and other interests. Many bankruptcy cases are designed and carried out as fast-moving vehicles for the liquidation of substantially all of the debtor’s assets. Furthermore, many bankruptcy cases that are at the outset intended to be reorganizations, quickly turn into liquidations due to lack of funding or a variety of other issues (and sometimes at the direction of post-petition lenders whose court-approved loan
documents may require that various actions, including in some instances the confirmation of a plan of reorganization, be taken or completed by the debtor pursuant to an accelerated schedule).

Many homebuilder cases in recent years have ended in liquidation. One of the significant advantages of the bankruptcy sale process is that purchasers receive the comfort of a court order authorizing the sale of assets free and clear of all liens, claims, encumbrances and other interests. Because distressed construction projects are frequently burdened with mechanic’s liens and other claims, the prospect of a sale “free and clear” makes the bankruptcy process attractive to purchasers who otherwise would be reluctant to bid on assets due to concerns about title and lien issues. In a case involving a Florida homebuilder, for example, the bankruptcy court approved the sale of residential lots free and clear of a restrictive covenant in a housing development plan that required a minimum sale price for the lots. Outside the context of a bankruptcy case, the restrictive covenant could not have been extinguished.

Some believe that bankruptcy courts are fast becoming the forum of choice for sales of businesses, troubled or not. Whether or not this was part of the intent behind Chapter 11 when enacted, the practice is here to stay.

The bankruptcy sale process under section 363 may provide benefits that range from *res judicata* findings that the sale is not a fraudulent conveyance or otherwise improper or subject to later avoidance; that directors and officers of the debtor have acted in good faith and in an exercise of their reasonable business judgment, consistent with their fiduciary duties; and that the purchaser shall not be liable as a successor of the debtor under non-bankruptcy law. These benefits, coupled with a 10 day appeal period and both statutory mootness under section 363(m) and equitable mootness under case law, makes a sale appeal difficult to prosecute successfully. Taken together, it is not hard to see why some view Chapter 11 as the ultimate mergers and acquisition statute.
The Code provides two separate and distinct sets of provisions under which a bankruptcy debtor or trustee may sell property free and clear of claims or interests: (1) pursuant to a plan or (2) in a non-plan sale. First, sections 1123(a)(5)(D) and 1141(c) govern sales made as part of a plan of reorganization confirmed after extensive disclosure and a multiple hearing process. Second, sections 363(b) and 363(f) govern sales prior to plan approval and impose only the Code’s minimal requirements for notice and a hearing.

In comparison to the plan confirmation process, the nonplan section 363(b) sale procedures require much less in the way of notice, disclosure, or opportunities for objectors and alternate bidders to actually be heard. That, coupled with the courts’ apparent willingness to make many findings that are beneficial to the seller, the buyer, the insiders, and the professionals in the case provides a speedy, effective way to accomplish a sale.

Section 363(b) allows sales of property of the estate out of the ordinary course of business, and section 363(f) permits a trustee or debtor-in-possession to sell property of the estate “free and clear” of liens or other interests in the property, if any one of five conditions is met:

The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if:

(i) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(ii) such interest 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;
(iii) such interest is in bona fide dispute; or

(iv) Such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Thus, section 363 can be used to authorize a pre-plan sale free and clear of interests through a motion to sell. Absent an objection, and assuming that the pleadings provide an evidentiary basis to support the sale, there is not even a need for a hearing although typically a hearing is held.

The term “interest”—the group of rights that an asset may be sold free and clear of—is not defined in the Code. Further, courts have largely ignored the absence of the word “claims” in section 363(f) and, despite the absence of the word, routinely approve pre-plan sales free and clear of claims as being within the power to sell free and clear of interests.

A Chapter 11 debtor whose goal is a sale free and clear will generally proceed straight to a pre-plan sale before (if ever) engaging in the costly and time consuming process of proposing, confirming, and consummating a plan of reorganization. In fact, it is not uncommon for reorganization cases that began with a plan as the goal to end with a pre-plan sale after things bog down in the middle of the case. The plan process can consume too much time, generate too much expense, or fail to result in a feasible exit strategy for the debtor.

Further, under section 363(m), an appeal of a sale order will likely be rendered moot if the sale has been consummated, assuming that requisite findings of good faith were made and no stay of the order is granted prior to the closing. Obtaining a stay generally requires posting a bond which can be prohibitively expensive. Section 363(m) provides:

The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section [which are implicated in any 363(f) sale] of a sale or lease of property does not affect the validity of a sale or lease under such authorization to
an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

Section 363(m) thus creates a race to close a transaction as soon after entry of the sale order as possible to prevent any stay from issuing and to moot potential appeals. Rule 6004(g) stays sale orders automatically for 10 days—which gives an objecting party time to seek a further stay while it appeals—but courts may, and often do, waive the 10-day stay in their sale approval order.

D. Findings of Fact and Conclusions of Law in Section 363 Sale Orders

Bankruptcy courts commonly enter extensive findings of fact and conclusions of law supporting section 363(f) sale orders. These typically contain detailed provisions insulating the seller, the purchaser, their insiders and professionals from liability. In practice, these findings of fact and conclusions of law are drafted by the debtor’s and the purchaser’s counsel, perhaps with comments from others such as the unsecured creditors committee. Despite the somewhat shaky foundation, the practice is widespread and generally accepted. The power to make these findings is thought to reside in subsections 363(b) and (f), or to emanate from section 105(a), the Code’s “all writs” provision.

Some less accommodating courts have recently examined the self-serving excesses of these kinds of sale-comfort orders and found many of their provisions to be not only improper but also unenforceable and not entitled to preclusive effect in later proceedings if they were not expressly determined in the sale motion proceeding.62

Although section 363(f) has been used to bar tort claims that arise post-sale from a product manufactured pre-sale or pre-petition, this practice is somewhat questionable. The most recent
decisions seem to somewhat foreclose application of section 363(f) to so called “future” tort claims by limiting the claims that can be barred on due process grounds.

E. Rights of Setoff/Recoupment

1. Setoff

Setoff is a right rooted in equity that permits the adjustment of mutual obligations by applying one debt in satisfaction of the other.\(^63\) The doctrine traces its origins to Roman law. Setoff was first incorporated into English bankruptcy law in 1705, and into the American Bankruptcy Act of 1800.\(^64\) The right of setoff continues to be recognized in modern bankruptcy practice.\(^65\)

Several provisions of the Code operate to preserve, protect, and limit rights of setoff in bankruptcy. In particular, section 553(a) recognizes and preserves rights of setoff where four conditions exist:\(^66\) (1) a creditor holds a claim against the debtor that arose before the filing of the bankruptcy case, (2) that creditor owes a debt to the debtor that also arose before the commencement of the case, (3) the creditor’s claim and debtor’s debt are mutual, and (4) the creditor’s claim and the debtor’s debt are each valid and enforceable.

The first requirement of section 553(a) is that a creditor must hold a prepetition claim against the debtor. Section 101 defines “claim” to include any “right to payment, whether such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.” By this language, Congress intended to adopt the broadest available definition for the term “claim.”\(^67\)

A claim is not ineligible for setoff simply because it is disputed. A court may permit the setoff of a claim notwithstanding a dispute as to its amount, and then later revisit the amount of the setoff or reverse the setoff to the extent that the disputed claim is ultimately resolved in the
debtor’s favor. Alternatively, the court may elect to resolve the dispute initially in the course of determining whether and in what amount to allow a setoff.68

In addition, section 553(a) requires that in order to be eligible for setoff the creditor’s claim must have arisen prior to the date of the filing of the debtor’s bankruptcy petition. In general, a claim is considered to have arisen prepetition if all of the elements of liability for the claim arose before the petition date.69 The issue of whether a claim arose before or after the commencement of the bankruptcy case is a question of federal bankruptcy law.70 Determining whether all of the elements of a claim arose before or after the commencement of the case is typically a straightforward analysis. The facts must be analyzed carefully, though, because sometimes that analysis can produce counterintuitive results.

One example of such a claim is the claim of a creditor settled during the course of the bankruptcy case itself. Intuitively, one would not expect that the mere settlement of a prepetition claim would render the claim postpetition in nature, and therefore ineligible for setoff. However, in Cooper-Jarrett, Inc. v. Central Transport, Inc.,71 the Third Circuit ruled that a postpetition settlement agreement that resolved the debtor’s prepetition breach of contract action against a creditor effectively converted that creditor’s prepetition debt into a postpetition liability, thereby rendering the debt ineligible for setoff under section 553 against the creditor’s prepetition claim.72

The second requirement of section 553 for setoff is that the debtor must owe a prepetition debt to the creditor against which the setoff may be taken.73 The term “debt” is defined in section 101 as a “liability on a claim.” Thus, for purposes of satisfying this requirement of section 553, the meaning of the term “debt” is virtually identical to the meaning of the term “claim.”74

The third requirement of section 553 recognized by courts is that the creditor’s claim and debtor’s debt must be “mutual.”75 Courts have held that this requirement should be strictly
construed. The term “mutual” is not defined by the Code, and the interpretive case law is rather confusing. Some courts have required that the prepetition claim and the prepetition debt must be owed between the “same parties,” and that the parties must be acting in the same “capacity.” Other courts have required that the obligations must be owed in the same “right.” Some cases suggest that the obligations need not be of the same “character” and that the prepetition claim and prepetition debt need not have arisen in any particular order or out of the “same transaction.”

The requirement that the prepetition claim and prepetition debt must exist between the “same parties” prevents triangular setoffs, in which A attempts to setoff an obligation owed by B against B’s debt to C. Such triangular setoffs are generally not allowed under non-bankruptcy law and are also not permitted under section 553. This rule, for example, prevents a subsidiary from setting off a debt owed to the debtor against a debt the debtor owes to another related subsidiary. This rule also applies to parent and subsidiary corporations.

The mutuality requirement to invoke the right of setoff in bankruptcy also requires that the parties must owe their obligations to each other in the same “capacity.” The requirement of “same capacity” differs from the “same parties” requirement in that it does not relate to the identity of the parties, but rather to the relationship between those parties. The parties to a setoff in bankruptcy must not only be the same as the parties to the original obligations, but those parties must also stand in the same capacity with respect to each other.

For example, courts have held that a bank cannot set off monies deposited by a debtor in a qualified retirement account at the bank against a general debt owed by the debtor to the bank, because the bank holds the retirement account deposit as a trustee and not as a creditor of the debtor-depositor. However, the requirement of “same capacity” does not prevent setoff if the
obligations sought to be offset between the parties are unrelated to either party’s fiduciary responsibilities.\textsuperscript{87}

Finally, the mutuality requirement to invoke a right of setoff in bankruptcy also requires that the parties’ obligations to each other must be owed in the same “right.”\textsuperscript{88} This means that each party to the setoff must own its claim in its own right severally, with the right to collect in its own name in its own right severally.\textsuperscript{89} The requirement that the parties’ obligations to each other be in the “same right,” for purposes of setoff in bankruptcy, subsumes the separate question of whether any obligations sought to be offset are owed jointly with some other entity.\textsuperscript{90} The “same right” requirement simply enforces the general rule that joint obligations are not subject to setoff against separate debts in bankruptcy.\textsuperscript{91}

Generally, the character of the obligations is irrelevant for purposes of mutuality under section 553. In the context of setoff in bankruptcy, a contract claim may be set off against a tort claim, and a statutory claim may be offset against an obligation arising in equity.\textsuperscript{92}

However, under general equitable principles, certain types of claims by a debtor are not subject to setoff by a creditor. For example, a creditor whose liability to the debtor arises from violations of the Truth in Lending Act may not offset that liability to the debtor by its own claim against the debtor.\textsuperscript{93}

Several courts have stated that a creditor whose liability to a debtor arises from fraud has no right of setoff under section 553.\textsuperscript{94} Likewise, where a creditor’s liability to the debtor is based upon the willful conversion of the debtor’s property, such as by a preferential transfer or a fraudulent conveyance, courts have refused to recognize such liability as a basis for setoff in bankruptcy.\textsuperscript{95}
The fourth requirement of section 553(a) for setoff is that the creditor’s claim and the debtor’s debt must each constitute a valid obligation. A prepetition setoff taken with respect to an obligation that is invalid under applicable non-bankruptcy law may be subject to avoidance.

It is important to bear in mind that section 553 does not create a federal right of setoff, but merely preserves in the bankruptcy forum whatever rights of setoff otherwise exist under applicable non-bankruptcy law. It follows that a court may not invoke section 553 to enlarge a party’s right to setoff in bankruptcy. Thus, in determining whether a creditor is entitled to claim a right to setoff in bankruptcy, a court must first look to non-bankruptcy law to ascertain the source of the underlying right. The substantive right to a setoff must arise independently under state or federal law.

However, the issue of whether setoff is permitted under section 553 in bankruptcy is a federal question that must be resolved by reference to the applicable provisions of the Code. Thus, even if a setoff would be allowed under applicable non-bankruptcy law, it will not be permitted in bankruptcy if the requirements for allowance under section 553 are not met.

The commencement of a case under the Code triggers the automatic stay of section 362. In particular, section 362(a)(7) expressly enjoins “the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor.” The automatic stay of section 362 does not defeat a creditor’s right of setoff, but rather enjoins enforcement of the right pending the orderly examination of the debtor’s and creditor’s rights in the bankruptcy proceeding. Because the automatic stay remains in effect, a creditor must affirmatively seek and obtain relief from the automatic stay under section 362(d) in order to assert its right of setoff.
It has been held that a creditor does not violate the automatic stay of section 362 by raising the existence of a right of setoff as a defense in a turnover proceeding under section 542. However, it has also been held that, in an adversary proceeding brought by the trustee against the creditor, the creditor must first obtain relief from the automatic stay before asserting its right of setoff as a counterclaim in that adversary proceeding.

The courts are divided over the issue of whether a setoff taken in violation of the automatic stay is void *ab initio* or merely voidable. A majority of courts have held that any action taken in violation of the automatic stay is void *ab initio*. A minority of courts have held that an action taken in violation of the automatic stay is merely voidable.

Section 506(a) expressly provides that “[a]n allowed claim of a creditor . . . that is subject to setoff under [s]ection 553 of this title, is a secured claim . . . to the extent of the amount subject to setoff . . . and is an unsecured claim to the extent that . . . the amount so subject to setoff is less than the amount of such claim.” Simply put, a creditor holding a valid right of setoff is to be treated as the holder of a secured claim to the extent of the right. With respect to the secured claim of a creditor holding a right of setoff, the creditor is entitled to all protections afforded secured creditors under the Code, including adequate protection.

Section 542(b) specifically provides:

[A]n entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under Section 553 of this title against a claim against the debtor. Thus, a setoff may be a defense to a trustee’s claim for turnover.
Generally, a creditor must timely assert its right of setoff in the debtor’s bankruptcy proceeding, or risk losing the right altogether.\textsuperscript{110} Although in general a creditor must file a proof of claim in order to share in any distribution from a debtor’s bankruptcy estate,\textsuperscript{111} a creditor that fails to file a proof of claim does not necessarily waive its right of setoff for all purposes.

There is a split of authority on the issue of whether a creditor that fails to indicate a right of setoff in its proof of claim can assert such a right. Some courts have held that a creditor can still assert its right of setoff notwithstanding such failure.\textsuperscript{112} Other courts have stated that a creditor’s failure to assert its right of setoff in its proof of claim filed in the bankruptcy amounts to a waiver of that right.\textsuperscript{113} Nonetheless, even if a creditor has a right to setoff under non-bankruptcy law, allowance of that right in bankruptcy is not mandatory but rather is within the discretion of the court.\textsuperscript{114} Courts appear to have adopted the view that the failure to file a proof of claim does not bar a creditor from asserting the right to setoff in a defensive manner against a debt owed to the debtor, but that such failure will prevent the creditor from receiving any distribution from the bankruptcy estate on account of the claim it asserts as a setoff.\textsuperscript{115}

Courts are divided over whether, in light of section 553(a), a creditor’s right of setoff is affected by confirmation of a plan of reorganization or liquidation, or by discharge of the debtor. A majority of courts have held or stated that confirmation and discharge do not prohibit the defensive use of setoff by a creditor in a subsequent action by the debtor against the creditor.\textsuperscript{116} Various bankruptcy courts have followed the logic of these decisions.\textsuperscript{117} A minority of courts, however, have taken the opposite view.\textsuperscript{118}

In general, a prepetition setoff is not avoidable as a preference under section 547\textsuperscript{119} or as a fraudulent transfer under section 548 or section 544.\textsuperscript{120} A prepetition setoff may be avoidable as a preference or fraudulent transfer, however, if the setoff was invalid under applicable non-
bankruptcy law, or if the setoff does not satisfy the requirements of sections 553(a)(2) or 553(a)(3).

Even if a creditor’s claim is disallowed under some provision of the Code, nonetheless, section 553(a)(1) does not operate to make a prepetition setoff based on that claim subject to avoidance as a preference or fraudulent transfer.\textsuperscript{121}

2. \textit{Recoupment}

“[R]ecoupment is in the nature of a defense and is intended to permit . . . judgment to be rendered that does justice in view of the one transaction as a whole . . . allowing the creditor to recoup damages simply allows the debtor precisely what is due when viewing the transaction as a whole.”\textsuperscript{122} Recoupment is not mentioned in the Code but has been applied in the bankruptcy context.

Bankruptcy courts apply recoupment as an equitable doctrine to permit a creditor to avoid the otherwise inequitable results of applying the limitations of setoff. The recoupment doctrine in bankruptcy is primarily applied to cases involving single contracts that expressly provide for the repayment of advances or overpayments, although use of the doctrine does not depend on whether the parties expressly anticipated the problem.\textsuperscript{123}

Recoupment and setoff are very similar doctrines, but in the bankruptcy context they have some key differences:

1. Generally, the requirements and limitations of section 553 do not apply to recoupments;
2. There is no prepetition requirement;
3. Although the courts are split, the trustee may not need to obtain relief from the automatic stay in order to exercise its right of recoupment; and
4. Unlike setoff, the obligation in recoupment must arise from the “same transaction.”
Courts have construed the principle of recoupment narrowly so as not to severely disrupt the fundamental bankruptcy tenet that “once a petition is filed, debts that arose before the petition may not be satisfied through postpetition transactions.”

In order to limit the doctrine of recoupment, courts require that “the creditor . . . have a claim against the debtor that arises from the same transaction as the debtor’s claim against the creditor.” Courts, however, have failed to precisely define what is a “same transaction.” Courts have instead focused “on the facts and equities of each case.” Courts generally adopt one of the two following tests: the integrated transaction test or the logical relationship test. It should be noted that “[u]nder either standard . . . courts evaluate the equities of the case, the main difference between them being the degree of interconnectedness required with respect to the relevant obligations.”

The integrated transaction test is the more restrictive approach in determining whether recoupment is justified. This test requires that “both debts … arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations.” Under the integrated transaction test, the same contract does not necessarily mean the same transaction. This test is used by the Second, Third, Fifth, Eighth, and Tenth Circuits.

The logical relationship test is the more flexible approach in determining whether recoupment is justified. Courts using this test find that “‘[t]ransaction’ is a word of flexible meaning. It may comprehend a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship.” Courts that have applied this standard in the context of a recoupment “have permitted a variety of obligations to be recouped against each other, requiring only that the obligations be sufficiently interconnected so that it
would be unjust to insist that one party fulfill its obligation without requiring the same of the other party.”\textsuperscript{133}

\textbf{F. Subrogation Claims}

It is well-recognized that a surety who has been compelled to pay the debts of its principal obtains a right of equitable subrogation. In \textit{Pearlman v. Reliance Insurance Co.},\textsuperscript{134} the Supreme Court addressed the issue concerning the relative rights as between the trustee of a contractor’s bankruptcy estate and the surety over which had the superior right to title to contract funds due the contractor from the United States in connection with a government construction project. The Court stated:

\begin{quote}
We therefore hold . . . that the government had a right to use the retained funds to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of the fund; that the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the funds; and that the surety, having paid the laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it. . . . Consequently, since the surety in this case has paid out more than the amount of the existing fund, it has a right to all of it.\textsuperscript{135}
\end{quote}

In essence, the Court held that the retainage was not property of the debtor’s estate because the surety had an equitable lien on the fund before the bankruptcy was filed.

Although \textit{Pearlman} was decided under the Bankruptcy Act in effect prior to the current Code, courts continue to recognize its binding effect.\textsuperscript{136} \textit{Pearlman}, however, leaves certain questions unanswered. For one thing, \textit{Pearlman} dealt with a Chapter 7 case where the debtor had defaulted on the project and the surety had paid to have the project completed prior to the
bankruptcy filing, leaving a fight over the retainage. It is not clear whether *Pearlman* applies in a Chapter 11 case where the construction contract is still in effect and the progress payments become due. Some courts have limited the surety’s rights to retainages and have stated that the progress payments belong to the contractor’s bankruptcy estate. Other courts hold that the surety is entitled to progress payments.\(^{137}\) Other courts hold that the surety is entitled to progress payments.\(^{138}\)

*Pearlman* does not address issues among the surety and other creditors of the contractor to retainages. For example, the bank with a security interest in the contractor’s assets, including accounts receivable and general intangibles, and even including the undisbursed loan proceeds held by the bank, may assert an interest and claim its interest as superior to that of the surety. Most courts that have addressed this issue have ruled in favor of the surety.\(^{139}\)

Unpaid suppliers and laborers may also claim an interest in retainages and progress payments. Most cases hold that unless and until the work is completed and those claims are paid, the surety’s subrogation rights in contract balances do not ripen and the balances are not payable to the surety.\(^{140}\)

### III. Isolating or Segregating Assets from Property of the Estate

When a construction or development entity declares bankruptcy, the first job of an attorney is to determine what assets are property of the estate. Statutory trusts arising under applicable state law, express trust agreements between the parties, or constructive or equitable trusts imposed by the court may enable the client to successfully gain a priority claim to the funds in question, or otherwise segregate the funds owed to the client from those of the debtor’s estate. The mere fact that a debtor lists an asset as property of the estate does not necessarily make it so in light of other controlling law.
A.  **Earmarking Assets**

Earmarking is a defense used against preference actions in bankruptcy. In a preference, a transfer may be avoided where it was a transfer of an interest of the debtor in property, to or for the benefit of a creditor, on account of an antecedent debt, made while the debtor was insolvent, made within 90 days of petition date, and enabled the creditor to receive more than it would have in a Chapter 7 liquidation.\(^{141}\)

Essentially, the earmarking doctrine provides that the debtor’s use of borrowed funds to satisfy a preexisting debt is not deemed a transfer of property of the debtor, and, therefore, it is not avoidable as a preference.\(^{142}\) Under the doctrine, if a third party provides funds for the specific purpose of paying a creditor of the debtor, the funds may not be recoverable as a preferential transfer because the funds never become part of the debtor’s estate.\(^{143}\)

Courts uniformly agree that three requirements must be met in order to apply the earmarking doctrine as a defense to a preference action.\(^{144}\) First, there must be an agreement between the new lender and the debtor that the new funds will be used to pay a specified antecedent debt. Second, the performance of the agreement must be made according to its terms. Third, the transaction as a whole (including the transfer in of the new funds and the transfer out to the old creditor) must not result in any diminution of the bankruptcy estate.\(^{145}\)

B.  **Contract Payments or Receivables, Trust Fund Statutes and Express Trusts**

1.  **Express Trusts**

An express trust is generally created by declaring the intent to create a trust, along with identifying the trustee, beneficiary, and the *res*.\(^{146}\) However, such trusts also may be created by statute.\(^{147}\) If an express trust is imposed, the assets in question will not become property of the estate.\(^{148}\)
Certain states have enacted “builders’ trust fund” statutes, which some practitioners may be too quick to assume automatically create an express trust, such as would prevent funds being held by the debtor from ever becoming property of the estate. The analysis is not so simple. A trust fund statute is not necessarily a trust fund statute for purposes of bankruptcy. Differences in language affect whether a trust fund statute creates the necessary “express trust” to prevent the property from becoming part of the debtor’s estate. Otherwise, the statute may simply provide a remedy to an aggrieved creditor without going so far as actually segregating the funds from a debtor’s estate.

The distinction appears to be whether the trust was created at the moment the funds came into the debtor’s possession or whether the obligation arose after the commission of a misapplication of the funds. As the U.S. Supreme Court said in Davis v. Aetna Acceptance Co., “It is not enough that, by the very act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee ex maleficio. He must have been a trustee before the wrong and without reference thereto.” 149

This critical distinction has been recognized by nearly all circuits. Where obligations arise at the moment the funds came into the debtor’s possession, the applicable builders’ trust fund statute creates a trust, preventing the funds from becoming property of the bankruptcy estate. On the other hand, where the obligations arise after the fact of a wrongdoing, there is no such trust.

Parties may argue, particularly in states without statutory express trusts, that funds represented by joint check agreements should never became property of the estate. If a joint check agreement specifically meets the criteria for an express trust, 150 the argument may prevail with the property remaining separate from the bankruptcy estate. 151 Not all joint check agreements,
however, meet the applicable criteria. For example, a unilateral letter of instruction from the debtor with no consideration that is revocable at will is not sufficient to establish an express trust.\textsuperscript{152}

2. \textit{Constructive Trusts}

What happens if there has not been an express trust created, either by statute or written agreement? Can a subcontractor still seek to have a “constructive trust” imposed on certain payments from the owner to the contractor, such that even though the proceeds are property of the debtor’s estate, they can nonetheless be equitably separated and directed to the benefit of the supplier? The first step in the analysis depends on state law, because bankruptcy courts will defer to the applicable state law in determining whether a constructive trust has come into existence.

Some circuits appear to be amenable to the idea of a “constructive trust” where the circumstances warrant. In this regard section 541(d) treats constructive trusts the same as express trusts.\textsuperscript{153} For instance, the Third Circuit specifically upholds the concept of constructive trusts for purposes of excluding from debtor’s property that property in which the debtor holds only legal, but not equitable, title.\textsuperscript{154} Other courts appear to make the distinction not between legal versus equitable title, but whether the circumstances warrant the imposition of a constructive trust under applicable state law, even as both legal and equitable interests remain in the hands of the debtor.\textsuperscript{155} Many of these cases, however, require the ability to trace the funds in question.\textsuperscript{156}

Regardless of the distinction relied upon by the court concerning legal versus equitable title, there is a common thread to constructive trusts: unlike an “express” or “resulting” trust, which can never be included in “property of the estate,” a constructive trust is a \textit{remedy} for circumstances in which equity demands that a trust be imposed after considering all the facts.\textsuperscript{157}

Certain other courts, following the lead of the Sixth Circuit in \textit{In re Omegas Group, Inc.},\textsuperscript{158} reject the entire concept of constructive trusts in bankruptcy, or at least for purposes of segregating
assets. The *Omegas* court held that when a prepetition fraud that would allegedly permit imposition of a constructive trust on the debtor’s assets injures the creditor, but when no constructive trust is imposed prior to the debtor’s bankruptcy filing, the creditor’s proper remedy is not to seek to exclude assets from property of the estate based on a constructive trust not yet in existence. Rather, the proper remedy is to file a non-dischargeability complaint to except the resulting debt from discharge.\(^{159}\) As the court noted in *In re Foros*, a “constructive trust” is a remedy for unjust enrichment, not a real trust; therefore the existence of grounds for imposition of a constructive trust does not lead to the conclusion that the beneficiary has an equitable, or any other, interest in the property. Instead, the beneficiary has a particular remedy for a legal wrong.\(^{160}\)

There is reason to believe that the Sixth Circuit’s approach, besides being the minority approach on the issue, will be abandoned. Not only has the holding been regularly criticized, distinguished, and not followed, but it also appears to be inconsistent with the U.S. Supreme Court’s pronouncements on the issue, as well as the majority of circuits. As noted by the court in *Paul J. Paradise & Assocs., Inc.*:

The *Omegas* decision is appealing in that it applies a bright line rule to resolve the confusion over the applicability of constructive trusts to bankruptcy law. Not surprisingly, it has met with approval by some bankruptcy courts. However, the Sixth Circuit panel’s blanket statement in *Omegas*, that constructive trusts come into existence at the time they are expressly recognized by a court, made without citation to any case authority, runs counter to the teaching of Third Circuit and Supreme Court law, that courts must look to state law to determine whether and when constructive trusts attach in bankruptcy law. The majority state law rule is contrary to that announced by the *Omegas* court; that is, the majority rule is that
constructive trusts attach or relate back to the time of the unlawful act that led to the creation of the trust. While the Delaware Supreme Court has described the constructive trust as an “equitable remedy,” that Court has also stated that “the duty to transfer the property relates back to the date of the wrongful act that created the constructive trust.” Thus, Delaware law appears to be in accord with the majority rule.\textsuperscript{161}

So in those states where constructive trusts may be recognized, what has been held sufficient and what has been held insufficient?

1. Merely establishing a procedure for joint checks, revocable at will by any party, is not sufficient to establish a constructive trust.\textsuperscript{162}

2. A persuasive factor in inducing courts to impose a constructive trust, despite whatever other failures a joint check agreement may have, is whether the agreement creates an independent obligation on the part of the owner to pay the supplier, and the supplier relies on that independent obligation.\textsuperscript{163}

3. Courts also apparently have been persuaded when there is clear evidence that the entire payment represented by the joint check is solely for the benefit of the supplier and no portion thereof appears to be for markup to the debtor. Therefore, while the funds may well be “property of the estate” because of the failure to create a specific res identified in the joint check agreement, the court nevertheless may make a distinction between “legal title” and “equitable interest” and order the check paid to the supplier. In such case, there is an explicit or implicit finding that the debtor is a mere “conduit.”\textsuperscript{164}

4. On the other hand, where both parties have an independent interest in the check, then notwithstanding any language in a joint check agreement, it is property of the estate.\textsuperscript{165}
5. Where the debtor has effectively entirely given up control over the payment, a constructive trust has been found to be warranted.\textsuperscript{166}

6. Where a constructive trust on a check has been found to be warranted, courts have not been impressed by debtors’ creative attempts to treat their obligations to sign over the joint checks as being “executory contracts” subject to rejection in bankruptcy. Because courts retain the right to approve or reject a proposed rejection of an executory contract under the Business Judgment Rule, a court can prevent an attempt to circumvent a finding of constructive trust by such unique maneuverings of a debtor.\textsuperscript{167}

3. \textit{Reclamation Rights}

Another way to declare assets as beyond the reach of the debtor is by virtue of reclamation rights under state law. Under this theory, recovery of certain assets delivered to the project may be permitted.\textsuperscript{168} Although bankruptcy courts recognize reclamation as a remedy based in state law rather than recognizing it as a separate bankruptcy right, the Code nevertheless affects the timing provisions of reclamation. Specifically, the 2005 amendments to the Code extend the 10-day period to up to 45 days (or, if the 45 days expire after commencement of the case, the demand must be made within 20 days of commencement of the case).\textsuperscript{169} Still, counsel should note that a creditor may not wish to pursue reclamation rights in light of a new provision added by the 2005 amendments to the Code. Section 503(b)(9) now provides for administrative expense status for goods sold in the ordinary course of the debtor’s business (as opposed to the ordinary course of the creditor’s business). Relevant issues to consider include the timing of when the goods were received by the debtor and their value.

The area of undisbursed construction loan proceeds brings together a number of competing interests. The commencement of a bankruptcy case creates a bankruptcy estate consisting of all
legal or equitable interests of the debtor in property wherever located and by whomever held.\textsuperscript{170} Applicable non-bankruptcy law determines the nature of the debtor’s interests in property and federal bankruptcy law controls whether that property becomes property of the estate.\textsuperscript{171} The Supreme Court has held that “property of the estate” is to be defined broadly and in a Chapter 11 case even includes property removed from the debtor’s possession before the bankruptcy petition is filed.\textsuperscript{172}

Several parties in a construction case may assert claims to undisbursed contract proceeds. First, the debtor will argue that the funds belong to it to use to complete the project.\textsuperscript{173} A lender may claim the funds as collateral for its secured claim to all of the debtor’s receivables. In states with trust fund construction lien statutes, bankruptcy courts have held that undisbursed funds are held in trust by the owner for payment of all unpaid contractors, subcontractors, and suppliers, even if they have not perfected construction liens against the project.\textsuperscript{174} Even in jurisdictions that do not have trust fund statutes, courts have sometimes held that contractors, subcontractors, and suppliers are constructive trust beneficiaries of such monies with the debtor holding near legal title to the funds.\textsuperscript{175} Finally, any surety who has performed or paid claims on behalf of its principal may claim entitlement to the undisbursed funds.\textsuperscript{176}

IV. Securing Contract Performance Claims Against Non-Debtors

A. Claims Against Sureties Under Performance Bonds

The effect of a Chapter 11 filing on a surety is felt most strongly in connection with the bankruptcy of the contractor for whom the surety posted performance and payment bonds. Various issues arise, including (i) a surety’s right to control performance and to take over and complete the construction contracts; and (ii) a surety’s right to contract balances, including retainages.
Depending on the performance of the contractor, the surety and the project owner may wish to join forces to attempt to oust the contractor and obtain control over the project, themselves.

Normally, an indemnity agreement would give the surety a right to control performance of the construction project and to take over and complete the contract in the event of its principal’s insolvency or bankruptcy, or in the event of a default. If, however, these rights have not been exercised before the contractor files bankruptcy, the automatic stay will prevent that from occurring absent approval of the bankruptcy court. Moreover, the contractor may seek to assume any construction contract. As already noted, the contractual right to terminate a contract because of the debtor’s insolvency or bankruptcy filing is not enforceable. Therefore, in order to assume the construction agreement, the contractor will be required to cure any default existing under the agreement and give adequate assurance of future performance. This can be a critical moment for the surety. If the debtor is allowed to assume the contract but subsequently bungles the project, the surety’s potential for damages increases dramatically. Therefore, it will wish to participate and, if appropriate, object to the assumption. In objecting to assumption, the surety will need to establish one or more of the following elements:

1. That the debtor cannot cure preexisting defaults and cannot provide adequate assurance of future performance of the contract;

2. That the debtor’s assumption of the contract will be a burden on the bankruptcy estate because claims incurred in the course of trying to complete will have administrative expense priority status; and

3. That it is in the best interest of all parties to require the debtor to reject these contracts so that the surety may take over and complete or arrange for completion as expeditiously and inexpensively as possible.
The surety may also seek to terminate its bond by obtaining relief from the automatic stay. A surety bond is a financial accommodations contract and therefore may not be assumed by the debtor without the consent of the surety. If the construction project is in its early stages and there are no defaults by the contractor, early termination is beneficial to the surety because it may be able to cut off future liability to subcontractors and other beneficiaries of the bond. If there are significant arrearages, however, and the project is not yet completed, the surety should be cautious in terminating the bond because it might jeopardize its right to be subrogated to the liens of some contractors and suppliers upon completion and payment of those parties in full.

The automatic stay does not enjoin actions against a surety under a performance bond because the bonding company is not the debtor, and the bond pledged by the bonding company is not an asset of the debtor or the estate. In the unusual case where the debtor pledges its own assets as the bond, however, the debtor's pledged assets are protected by the automatic stay.

The procedures for triggering the surety’s obligations under a performance bond vary depending on the express and implied terms of the bond, the bonded contract, and the type of bond. Private performance bonds are commonly modeled after form documents promulgated by the AIA (A311 and A312), the Engineers Joint Contract Documents Committee (EJCDC C-610), and ConsensusDocs (ConsensusDocs 260).

The AIA provides two different performance bond forms: the AIA A312 (2010 and 1984 eds.) and the earlier AIA A311 (1970). A312 is the most widely-used traditional performance bond in private construction. The EJCDC’s C-610 is published and updated to be consistent with the language of the AIA A312 (2010 ed.), and they are nearly identical.

The A312 (2010 ed.) contains several procedural steps that an owner must follow to trigger a surety’s obligations under the bond. First, the owner must send a notice to the contractor and its
surety that it is considering declaring the contractor in default. The second condition precedent differs between the A312 (2010 ed.) and its predecessor, the A312 (1984 ed.). Under the A312 (1984 ed.), the owner must, not sooner than 15 days after the contractor and the surety have received the notice that the owner is considering declaring the contractor in default, request and attempt to arrange a meeting with the contractor and surety to discuss methods for performing the contract. Under the more recent A312 (2010 ed.), the owner need not request a meeting if it provides notice of potential default to the contractor and surety. However, the A312 (2010 ed.) does allow the surety itself to request such a meeting. Third, under both the 1984 and 2010 editions of the A312, the owner must, not sooner than 20 days after the contractor and the surety have received the notice that the owner is considering declaring the contractor in default, declare the contractor in default and formally terminate the contractor’s right to complete the contract. It is important to note that the A312 incorporates the underlying contract by reference, which may contain additional requirements for declaring default and terminating the contractor. Fourth, the owner must then agree to pay the balance of the contract price to the surety, or to another contractor selected by the surety. Finally, the AIA performance bond requires that the owner not be in default itself on the contract and follow the contract termination procedures, including any opportunities to correct the cited deficiencies as mandated by the contract and the applicable law.

The AIA A311 (1970) performance bond is the predecessor to the A312 and is still used on many construction projects, particularly public works projects. The default procedures under the A311 are simpler than those under the A312. The conditions precedent for surety liability under the A311 are limited to a default by the contractor, declaration by the owner of that default, and that the owner itself not be in default. Another important difference between the A311 and the A312 is that the A311 does not require the owner to agree to pay the balance of the contract
price to the surety. Based on the broad terms of the A311, courts have come up with varying interpretations of the conditions precedent. Depending on the applicable state and federal case law, an owner may or may not be required to give notice of default to the surety, make a formal declaration of default, or formally terminate the contractor.\textsuperscript{181} In order to adequately understand the conditions precedent under the A311, a careful review of the applicable jurisdiction’s law is required.

In 2007, ConsensusDocs published a new standard form performance bond, ConsensusDocs 260. This form contains similar provisions to the A311, but with more modern language. The conditions to triggering the surety’s obligations under ConsensusDocs 260 require the owner to: (1) declare the contractor to be in default, (2) make a demand on the bond to the surety, and (3) make the amount of the contract balance available to the surety. The owner also must not be in default under the contract. Among other differences, ConsensusDocs 260 does not require a pre-default meeting as required by the A312.

To the extent that a performance bond requires termination of a defaulting contractor as a condition precedent to triggering a surety’s obligations under a performance bond, as already noted, an owner or upstream contractor may not terminate a debtor’s contract without first obtaining relief from the automatic stay. However, if a motion for relief from the automatic stay is contemplated to terminate the contract of the debtor, an owner or upstream contractor may be able to “start the clock running” to satisfy the third condition precedent to such a termination under the A312 (1984 ed.) by satisfying the first two conditions precedent. Relief from the automatic stay is likely not required to send a \textit{notice} to the contractor and its surety that the owner is \textit{considering} declaring the contractor in default and \textit{requesting} or \textit{attempting to arrange} a meeting with the contractor and surety to discuss methods for performing the contract. As long as the letter
is non-demanding and sets forth in a straightforward informational manner the notice and/or request, it will likely not be deemed to violate the automatic stay. Even if these steps are not taken, however, the automatic stay does not prevent an owner or upstream contractor from notifying the performance surety of the debtor’s bankruptcy and the debtor’s failure to perform under the bonded contract. Most sureties will spring into action immediately, because their rights will be dramatically affected by the principal’s bankruptcy.

As already noted, a debtor-in-possession in a Chapter 11 bankruptcy may assume or reject executory contracts at any time before confirmation of a plan of reorganization. Many contractors who file a Chapter 11 bankruptcy will not elect whether to assume or reject executory contracts at the time the bankruptcy petition is filed, but will instead just let things ride until forced to decide whether to assume or reject. Under section 365(d)(2), “on the request of any party to [an executory] contract … [the court] may order the trustee [or debtor-in-possession] to determine within a specified period of time whether to assume or reject such contract.” Given the time-sensitive nature of construction contracts, a surety and performance bond obligee should be able to establish the significant harm that delay in deciding whether to assume or reject an executory construction contract will cause. An upstream contractor can show the likelihood of incurring substantial exposure to claims for consequential damages or liquidated damages from the owner if the project is delayed by the debtor’s inactivity. They should also be able to demonstrate the almost insurmountable impediments that a debtor will have to overcome to assume the contract.

As already noted, in order to assume an executory contract under section 365(b), a debtor must (1) show that it has cured, or provide adequate assurance that it will promptly cure, its defaults under the contract, (2) compensate, or provided adequate assurance that it will promptly compensate, the owner for any actual pecuniary loss resulting from its defaults, and (3) provide adequate assurance
of future performance under the contract. This can be virtually impossible for a bankrupt contractor.

If the construction contract in question is a bonded project, perhaps the biggest hurdle the contractor will have to overcome to assume the contract is to provide a surety bond for post-petition performance. This fact provides the surety and the obligee with enormous leverage. Because surety bonds are financial accommodation contracts that cannot be assumed in bankruptcy without the consent of the surety, the bankrupt debtor must either convince the surety to continue as its performance surety during post-petition performance or find a new surety. Obtaining a new surety to guarantee a bankrupt’s post-petition performance can be an impossible task.

B. **Performance on Non-Bonded Projects**

Finally, even on construction projects that do not involve performance bonds, if a contractor is not performing post-petition, an owner or upstream contractor can usually exercise self-help in attaining performance of the bankrupt contractor’s contract while moving for relief from the automatic stay and/or moving to compel the debtor to reject the contract. If it is critical that work proceed and the debtor is not performing post-petition, an owner or upstream contractor can usually supplement the work of the nonperforming contractor. While there is a risk that the owner or upstream contractor may end up paying twice for the supplemented work if the contract is not ultimately rejected or terminated, this risk can be outweighed by the risk of exposure to substantial consequential damages or liquidated damages if completion is not timely attained. Most construction contracts contain language giving an owner or upstream contractor the right to supplement the work of a nonperforming contractor. Such provisions sometimes require notice to the defaulting contractor of the owner’s intent to exercise such right if the contractor fails to perform after some period of time following receipt of the notice.
Again, as long as such notice is non-demanding and sets forth in a straightforward informational manner the fact that the contractor’s work will be supplemented if the contractor does not perform pursuant to the contract, it will likely not be deemed to violate the automatic stay.\textsuperscript{183} If the nonperforming contractor’s contract is subsequently rejected or terminated, the owner or upstream contractor should be able to offset the costs of supplementation against the unpaid contract balance under the indemnity provisions of the contract. Note that relief from the automatic stay will also be required to exercise and assert that right of setoff.

IV. Securing Contract Payment Claims Against Non-Debtors and Assets That Are Not Property of the Estate

A. Private Projects

To properly commence a lien claim, it must both be filed within a certain time frame and then a lawsuit must be brought within another set time period thereafter.\textsuperscript{184} Mechanics and materialmen’s lien claims may be filed by recording a Memorandum of Lien or similar document after the commencement of a bankruptcy case. The automatic stay does not prevent this filing.\textsuperscript{185} The rationale is that liens arise under state law when the work is performed and the material is delivered (the filing relates back to the first day work was performed or materials were delivered). So the recording of the lien after the bankruptcy is filed does not "create" the lien but merely gives the public notice of its existence. While the stay prohibits filing of a lawsuit to enforce the lien, the code extends the period for filing the enforcement suit for 30 days after the stay has been lifted. Therefore, claimants may continue to record a lien after bankruptcy has been filed notwithstanding the automatic stay.
Therefore, if the claimant provided work or supplied material prior to the bankruptcy filing, the lien is allowed to be filed after the bankruptcy filing and the claimant’s rights should generally survive a bankruptcy and will not be discharged.\textsuperscript{186}

\textit{1. Statutory Mechanic’s Liens}

A mechanic’s lien is a powerful tool contractors have to preserve their rights against an upstream debtor, as it can elevate the contractor from unsecured to secured creditor status. In many states, the lien is perfected by filing a memorandum of lien or similar document in the clerk’s office of the appropriate city or county. Lien enforcement, however, is a separate action, normally pursued through a lawsuit, often subject to a one-year or other statute of limitations. Filing to perfect a mechanic’s lien is not subject to the automatic stay.\textsuperscript{187} This means that the timeline for filing a mechanic’s lien is unaffected by the bankruptcy proceeding; the filing of a bankruptcy petition does not stay the normal time requirements, and the failure to meet those requirements can be fatal. Enforcement of the mechanic’s lien, on the other hand, is subject to the automatic stay.\textsuperscript{188} Once the memorandum of lien is filed, the contractor has two options in light of the bankruptcy: (1) file a motion seeking relief from the automatic stay for the purpose of enforcing the lien, or (2) serve the debtor or trustee with a notice pursuant to the Code, which serves to continue the lien until the automatic stay is terminated.\textsuperscript{189} Once the stay is terminated, the contractor needs to file suit to enforce the lien.\textsuperscript{190}

A mechanic’s lien is treated by the Code as a statutory lien that may be avoided under certain circumstances, including for defects in the perfection of the lien. Pursuant to sections 362(b)(3) and 546(b)(1) of the Code, a mechanic’s lien may be perfected after the commencement of a bankruptcy case without violating the automatic stay if applicable state law permitted the relation back of the lien. According to a recent homebuilder case, “the net effect of these two
provisions [i.e., sections 362(b)(3) and 546(b)(1) of the Code] is to authorize an entity to perfect an ‘interest in property’ after the filing of a petition to the extent state law provides for perfection to relate back to the pre-petition interest.”

In addition, section 546(b)(2) of the Code provides that, where perfection of a mechanic’s lien requires the seizure of property or the commencement of a lien foreclosure action, the mechanic’s lien claimant may perfect by filing a notice with the court in lieu of seizure of the property or the commencement of a lien foreclosure action.

Mechanic’s lien issues turn on the application of state law, and each state has different technical requirements for the assertion and perfection of mechanic’s liens (including different requirements regarding when a lien arises and whether it relates back to the date of the occurrence of an event specified by a statute such as the filing or service of a lien notice). Given the differences in state mechanic’s lien laws, practitioners should review the law of the particular state within which a construction project is located in determining the effect of a bankruptcy filing on the rights of mechanic’s lien claimants.

2. Statutory Stop-Payment Notices or Notices of Owner Personal Liability

In addition to the right to a statutory mechanic’s lien against real property codified in every state, some states have also enacted legislation permitting a subcontractor or material supplier on a private project to place a lien on unpaid contract funds held by the owner of the project. The remedy is commonly referred to as a “lien on funds,” or “stop-payment notice,” or “owner personal liability notice.” Unlike mechanic’s liens, which provide contractors, subcontractors, and material suppliers with a lien on real estate, these claims available to subcontractors and material suppliers create a security interest or claim to unpaid construction funds held by the project owner. The claim or lien is typically perfected by sending a notice of the claim to the owner.
or lien is perfected, an owner becomes personally liable for payment of the claimed amount out of any contract balance that has not yet been paid to the contractor, and must retain enough funds from payment to the contractor to satisfy the claim or lien. If the owner pays the liened funds to the contractor after receiving the notice, the owner becomes personally liable for payment of the claimed amount to the claimant.

It is generally held that the automatic stay does not operate to prohibit the perfection of such stop-payment notices. Courts are divided, however, on whether the claim or lien trumps the strong-arm powers of a bankruptcy trustee. Some courts hold that the claim of a subcontractor who issued a stop-payment notice prior to a prime contractor’s bankruptcy filing takes priority over the claim of the prime contractor’s bankruptcy trustee, but that the claim of the bankruptcy trustee for the prime contractor has priority over the claim of a subcontractor who issued a stop-payment notice after the prime contractor’s bankruptcy filing. Bankruptcy courts in other states hold that the claim of a subcontractor who issued a stop-payment notice, even after the bankruptcy filing by the prime contractor, has priority not only over the claim of the debtor-in-possession, but also a lender with a prior perfected security interest in all of the debtor’s receivables. The distinction appears to hinge on whether the statutory remedy creates a lien in the contract funds or merely a cause of action against the owner for payment of the unpaid contract funds. Practitioners should consult the statutes and authorities in the particular jurisdiction where the project is located.

B. Public Projects

1. Statutory Payment Bond Claims

As a general rule, a claimant may not file a lien against public property, whether the property is owned by the local, state, or federal government. As a result, special state and federal statutes require payment bonds of prime contractors on public works projects. The Miller Act,
first enacted in 1935, is the federal statute that requires that prime contractors post a payment bond for the protection of subcontractors, laborers, and material suppliers on all federal construction projects of significant size. Most states have also enacted statutes requiring prime contractors on state and local public works projects of significant size to post a payment bond to assure payment of subcontractors, laborers, and material suppliers. These statutes are sometimes referred to “Little Miller Acts.” As in the case of payment bond claims on private projects, perfecting and prosecuting a payment bond claim against a bankrupt contractor’s payment surety on a public project is not stayed by the automatic stay.

2. Statutory Impoundment Claims

In addition to payment bond remedies on public works projects, many states have also enacted statutes creating a payment remedy that provides the right for a subcontractor or material supplier to impound or lien unpaid contract proceeds held by the state or local government owner of the public work. This payment remedy is typically perfected by sending a notice or verified statement of claim to the state or local government owner. Once this claim or lien is perfected, the state or local government owner is required to withhold from payment to the prime contractor sufficient funds to satisfy the claimant’s lien or claim. If the prime contractor is in bankruptcy, the automatic stay does not operate to prohibit the perfection of this payment remedy. Because legislation in most states requires that government contracts contain a provision requiring the prime contractor to pay its laborers, subcontractors, and material suppliers, most government contracts contain indemnity provisions requiring the prime contractor to indemnify the government owner from and against all payment claims by the contractor’s subcontractors and material suppliers. As a result, such statutory claims to impound or lien unpaid contract proceeds held by the state or local government owner of the public work will generally prevail over the strong-arm
powers of the contractor’s bankruptcy trustee or the security interest in all of the contractor’s receivables by the contractor’s lender.

VI. Defending Against Preference, Fraudulent Conveyance, and Disgorgement Claims

By avoiding a particular transfer of property, the trustee or debtor-in-possession (DIP) can cancel a pre-petition (or, occasionally, an unauthorized post-petition) transaction and force the return or “disgorgement” of the payments or property, which then are available to pay all creditors pursuant to the priority rules set forth in the Code. These powers are used to prevent unfair pre-petition payments to one creditor at the expense of all other creditors. Below are the common avoidance powers in Chapter 11.

A. General Avoidance Powers

1. Fraudulent Transfers

A pre-petition transfer may be avoidable as either “intentional fraud” or “constructive fraud.” The former is a transfer made with actual intent to hinder, delay or defraud creditors. Think of the debtor-to-be who is being hounded by creditors, and so conveys his house and his bank account to his mother so that the creditors will not seize them. The latter is a transfer made for less than reasonably equivalent value, while the debtor is insolvent (or which renders the debtor insolvent or leaves it with unreasonably small capital). This category could include, for example, the sale of a $10 million factory for $3 million, or the payment of a dividend to shareholders by an insolvent corporation, even if there were no intent to harm creditors.

The Code includes its own fraudulent transfer power, set forth in section 548 which covers transfers in the two-year period prior to the petition date. But a trustee (or DIP) may also utilize state fraudulent conveyance laws, which tend to be generally similar to the federal statute, but with significantly longer reach-back periods.
2. **Strong-arm Powers**

Now, take, for example, a different case. Before bankruptcy, the debtor borrowed $1 million from BigBank and, to secure the loan, granted BigBank a security interest in its equipment. Typically, if BigBank wants to beat out competing third-party contenders, it will have to “perfect” this security interest—probably by filing a “financing statement” in the proper public records. If he fails to perfect, he will lose out to a competing creditor who gets a lien or share ratably with unsecured creditors.

Recall that the trustee is a kind of agent of creditors. So it is not surprising to learn that the trustee enjoys the rights of a lien creditor as of the petition date. In our case, this means that if the security interest is unperfected at the time of the bankruptcy filing, the trustee gets to set it aside.\(^{199}\)

3. **Preferences**

Now, yet another case. The debtor owes $10 each to three creditors. The debtor has assets worth only $10. He transfers all his assets to the Creditor A in satisfaction of the debt to Creditor A, leaving Creditor B and C. What is the result? Observe that under the two rules we described above, it is probably bulletproof. There’s nothing to indicate it could be set aside by a lien creditor. It (probably) was not done to defraud other creditors, and the debtor did get fair value for the payment (satisfaction of the $10 debt). Quite the contrary: Whatever the debtor did here, at least he paid a debt.

Preferring one creditor over another usually is not wrong outside bankruptcy. But bankruptcy is all about distributing assets among creditors “as their interests may appear.” If you let the debtor pick and choose whom he pays, you may upset the purpose of bankruptcy. Thus, bankruptcy law allows a DIP to avoid certain pre-petition debt repayments even though they would not be avoidable outside of bankruptcy.\(^{200}\) Typical examples of preferential transfers include the
late payment of a trade debt (outside the “ordinary course of business”), the granting of a security interest to a previously unsecured or under-secured lender, or delayed perfection of a security interest granted by the debtor at the time it incurred an earlier debt. The reach-back period for preferences is 90 days before bankruptcy, although it extends to one year if the recipient or other party who benefited from the transfer is an “insider” of the debtor.201

Vats of ink have been spilled over the trustee avoiding powers, and we don’t do any more than hint at the difficulties here. We raise the topic here mostly for one reason: the way you manage the avoiding powers may drive the Chapter 11 case. In some cases, the avoiding powers provide the motive for filing—either to recover the transfer or to use the threat of doing so to reach a deal. On the other hand, there may be cases where the debtor and parties in interest will finesse the avoidance problems in order to make a deal that wouldn’t happen otherwise.

B. Trustee’s “Strong Arm” Avoidance Power as Hypothetical Judicial Lien Creditor

Aside from section 548, there is a wholly separate line of attack for the DIP trying to avoid a fraudulent transfer. This is section 544(b) of the Code, which provides that the DIP may generally avoid a transfer “that is voidable under applicable law by a creditor holding an unsecured claim.” This means that the trustee may look to non-bankruptcy law (usually “state” law) and deploy any avoiding power that he finds there. The most common use of section 544(b) is to give the trustee a right of action under state fraudulent transfer law, the UFTA or UFCA. These are most often useful to the DIP because of the longer reach-back period available under state law. As noted above, under section 548 a DIP may avoid a fraudulent transfer only if it took place within two years prior to the petition date. However, depending on the state, the reach-back period under state law may be from two to six years.
There are occasionally other uses that a DIP can make of state fraudulent conveyance law—claims that exist under state law but not under section 548. For example, under the UFTA a transfer by an insolvent debtor to an insider who knew of the insolvency, on account of a debt owed to the insider, may be avoidable, even though it would (absent actual fraud) not be avoidable under section 548, because under section 548 “value” includes the satisfaction of an antecedent debt. This case may not come up every day, but it illustrates an important point: when considering a fraudulent conveyance action, the DIP should review the applicable state statute to determine what claims may be available. This is because 11 U.S.C. § 544(a)(1) provides that the DIP has the rights of a lien creditor.

C. Prepetition Transfers By or For the Debtor

1. Preference Claims

According to the Code, some payments made by the debtor to creditors pursuant to the pre-existing debt within the ninety-day period prior to bankruptcy filing may be “avoided,” that is, they must be refunded. The debtor is presumed to be insolvent during this pre-petition period, and it is viewed as inequitable for the debtor to favor or prefer some creditors over others. This avoidance power serves to ensure each creditor of the same class receives an equivalent proportionate share of the debtor’s estate and discourages the “race to the courthouse.” Preferential payments brought back into the estate, like other estate property, are shared by the debtor’s general unsecured creditors on a pro rata basis (after payment of administrative and priority claims).

In bankruptcy cases filed by general contractors, preference claims frequently are asserted against subcontractors and suppliers that received payments within the 90-day period prior to the date of the bankruptcy filing. If a subcontract or a supply contract has been assumed, there is no
risk of preference liability because the Code requires a debtor to cure all curable defaults and to otherwise perform under the subcontract or supply contract (and, as a result, there can be no argument that the subcontractor or supplier received any payment that it was not entitled to receive). If a subcontract or a supply contract has been rejected, however, preference claims may be asserted.

The Code identifies various technical elements that must be established to sustain a preference claim, as well as various defenses that may be used to defeat all or part of a preference claim. In some cases, subcontractors have defeated preference claims by arguing that they provided new value to the debtor (one of the defenses to a preference claim expressly recognized under the Code) through the release of lien rights that, but for their receipt of payment, would not have been released. In doing so, subcontractors have been able to distinguish themselves from general unsecured creditors that have no lien rights to release in exchange for payments. In other cases, however, courts have rejected the new value defense on grounds that the subcontractor’s lien rights had no value at the time the preferential payments were made.

2. **Defenses**

Many creditors simply comply with the demand letter from the trustee or the debtor-in-possession and return funds they received from the debtor during the ninety-day preference period. Others assert affirmative defenses to the preference actions. Any time you have a preference case, it’s a good idea to go through all the § 547(c) provisions to see whether any of them might apply. The affirmative defenses most common in the construction bankruptcy cases are that the transfer was a contemporaneous exchange for new value given to the debtor (the “contemporaneous exchange” defense), the transfer was made in the ordinary course of business of the debtor and creditor, or made according to ordinary business terms in the industry (the “ordinary course of
business” defense), the creditor shipped additional inventory or extended additional credit subsequent to the preferential payment, for which the creditor is entitled to a credit (the “subsequent new value” defense), and the transfer was the fixing of a statutory lien not avoidable under the Code (the “statutory lien” defense).211 The burden of proof is on the preference defendant, i.e., the creditor, to demonstrate that the elements of the affirmative defenses are met.212

VII. Minimizing Problems and Maximizing Recovery

In light of the above, there are both proactive and reactive ways for contractors to take advantage of available methods to elevate the priority of their claims and to minimize potential avoidance of received payments via available defenses.

A. Payment Terms

Once aware of the possibility of an impending bankruptcy, move the soon-to-be debtor to COD terms. This should set up a “contemporaneous exchange” defense to a preference action. Otherwise, attempt to maintain the payment terms and conditions previously used with the debtor in order to set up the ordinary course of business defense.

B. Mechanic’s Liens

Ensure mechanic’s liens are timely and properly perfected—and provide notice in the bankruptcy case—to qualify for the “statutory lien” preference defense. Absent such perfection, transfers within the preference period may not be shielded from avoidance.213 Even a timely perfected mechanic’s lien does not guarantee protection. For instance, if the value of the estate property against which a mechanic’s lien is asserted is not sufficient to fully secure the lien, any payment purportedly made in satisfaction of the lien is avoidable to the extent it exceeds the value.214

C. 45 Day Pre-Petition Period
Once a bankruptcy petition is filed, quickly evaluate any reclamation rights regarding goods received by the debtor during the forty-five-day pre-petition period in order to meet the short notice deadline. Determine the value of goods received by the debtor during the twenty-day pre-petition period and file a section 503(b)(9) administrative expense claim for that amount. Assess whether the debtor is holding any owed pass-through funds for which a constructive trust might exist and, if so, file suit in bankruptcy court (an adversary proceeding to seek such funds; the subcontractor pass-through funds in the above preference scenario likely would qualify). Finally, file a proof of claim for any remaining pre-petition debt in order to take advantage of any pro rata estate distribution.

VIII. Contract Strategies For Owners and Upstream Contractors

Preparing for the possibility of a downstream bankruptcy begins at contract formation. Even if one of the standard industry contract forms is utilized, revisions to or supplementation of those forms can provide an owner or upstream contractor the tools to manage a downstream bankruptcy on the project. For example, the contract should contain a provision requiring the contractor to furnish in writing the name, trade, and contract amount for each subcontractor and material supplier utilized on the project. This information can be invaluable if a downstream contractor files bankruptcy.

A. Assignment of Subcontracts

The contract should contain provisions allowing (but not requiring) assignment of all subcontracts and material supply agreements if the contract is terminated or rejected. It is rare that a terminated or rejected contract can be completed by a third party for less than the remaining unpaid contract balance. Allowing an owner or upstream contractor to require assignment of
downstream contracts can require a downstream contractor to complete its work for the unpaid balance of its subcontract.

B. Schedule of Values

The contract should include a requirement that all pay applications be accompanied by a schedule of values and detailed subcontractor breakdown of work and materials included in the pay application.

C. Conditional Lien Waivers

For each pay application, the contract should require the delivery of conditional lien waivers from all contractors and material suppliers for all work up through the period covered by each pay application and unconditional lien waivers from all contractors and material suppliers for all work up through the date of the prior pay application as a condition precedent to payment of the pay application. Absent fraud, this assures that the contractor is staying current in payments to its subcontractors and material suppliers.

D. Supplementation Provisions

The contract should contain terms to allow supplementation of the contractor's work and allowing others to provide any or all of lower-tier contractors’ or suppliers’ work or material supplies. In the event of a bankruptcy downstream, terms to this effect can be invaluable to progress the project using a replacement contractor or supplier because there is no need to terminate the contract to allow completion of the bankrupt entity’s scope of work if the debtor fails to perform post-petition.

E. Direct Payment, Joint Check, and Disputed Lien Provisions

The contract should contain terms that allow direct payment to subcontractors and vendors or payments to lower-tier contractors and vendors by joint check, and reserve the right to settle any
disputed lien or claim by any lower-tier contractor or vendor. If the contractor files bankruptcy, this will provide a contractual right to pay subcontractors and material suppliers directly, without giving rise to a breach-of-contract claim for refusing to pay the bankrupt contractor.

F. Reimbursement and Withholding Provisions

The contract should provide for reimbursement or payment from the contractor for any costs or expenses to cure any defaults of the contractor or to correct defective work. The contract should also preserve the absolute right to offset any amounts paid pursuant to any of the previous provisions, as well as any liquidated or consequential damages caused by the contractor’s breach or default, against the contract sum and to deduct the amount from any payment then or thereafter due the contractor.

The contract should also provide that payments otherwise due may be withheld on account of defective work not remedied, failure to make payments promptly to subcontractors or material suppliers, liens filed, claims made, or reasonable evidence indicating the probability that liens or claims will be asserted.

G. Setoff Provisions

The contract should allow for the setoff of amounts due under any contract with the contractor against amounts due under any other project or contract with the contractor. Jurisdictions are split as to whether, in the absence of such a provision, a payment owed by a contractor to a subcontractor on a particular project may be used to set off a debt owed by the subcontractor to the contractor on a different project. Generally, common law denies unliquidated claims from being used to set off liquidated claims.
**H. Indemnity Provisions**

The contract should also contain strong indemnity language, requiring the contractor to indemnify against any and all liens, claims, and losses, including attorney fees, arising out of the contractor’s scope of work. This creates a contractual right to indemnification by the bankrupt contractor for any payments to lower-tiered contractors or vendors who file or threaten to file liens or other claims such as stop-payment notices that could become secured claims against the owner or its property. Such contract terms make the bankrupt’s indemnity obligation a pre-petition claim, subject to set-off under section 553 as a secured claim under section 506(a), even if the amount of the claim is unliquidated until post-petition.

---

1 The authors thank Christopher Coleman, University of Tennessee College of Law Class of 2018, for his substantial assistance in the research and assembly of these materials.


4 11 U.S.C § 541(a)(1).


An examiner is a person normally with fewer powers than a bankruptcy trustee, but with the authority to investigate the debtor as to certain issues and report findings to the court. An examiner can have limited or expanded powers. See 11 U.S.C. §§ 1104, 1106.


See, e.g., Pintlar Corp. v. Fid. and Cas. Co. of N.Y. (In re Pintlar Corp.), 124 F.3d 1310 (9th Cir. 1997) (directors and officers liability policy, as opposed to indemnification policy, issued to Chapter 11 debtor not property of estate and therefore not subject to automatic stay); Edwards v. Armstrong World Indus., 6 F.3d 312 (5th Cir. 1993), rev’d on other grounds sub nom. Celotex Corp. v. Edwards, 115 S.Ct. 1493 (1995).


“Single asset real estate” means real property constituting a single property or project other than residential real property with fewer than four residential units, which generates substantially all of the gross income of the debtor on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto having aggregate non-contingent, liquidated secured debts in an amount not more than $4,000,000. See 11 U.S.C. §101(51B). The special treatment for single asset real estate cases stems from the perceived abuse of the bankruptcy process in cases which are essentially two-party disputes between a real estate developer and its secured lender. See, e.g., In re Phoenix Piccadilly, Ltd., 849 F.2d 1393 (11th Cir. 1988).


30 See, e.g., Borg-Warner Acceptance Corp. v. Hall, 685 F.2d 1306 (11th Cir. 1982).

31 See Budget Serv. Co. v. Better Homes of Va., Inc., 804 F.2d 289 (4th Cir. 1986) (affording relief under Section 362(h) to a corporate debtor).


40 15 U.S.C. § 77ppp(b)

41 15 U.S.C. § 77aaaa

42 If you are thinking of entering into a post-petition lockup agreement, have a look first at Judge Walrath’s decisions in NII Holdings Inc., Case No. 02-11505 and NII Holdings Inc., Case No. 02-11505 (MFW).


44 11 U.S.C. § 546(c)(1). See also In re Advanced Mktg. Serv., Inc., 360 B.R. 421, 426 (Bankr. D. Del. 2007) (“[U]nder the express language of § 546(c)(1) of the Code, [the lenders’] pre-petition and post-petition liens on the Debtor’s inventory are superior to [the seller’s] reclamation claim.”).


53 Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1045 (4th Cir. 1985).

54 11 U.S.C. § 365. An executory contract is one where performance still is due by both sides, i.e., “if the ‘obligations of both the [debtor] and the other party to the contract are so far unperformed that he failure of either to complete the performance would constitute a material breach excusing the performance of the other.” Lubrizol Enters., Inc., 756 F.2d at 1045 (4th Cir. 1985); See In re Ideal Mortg. Bankers, Ltd., 539 B.R. 409 (E.D.N.Y. 2015).

55 Such “ipso facto” or “default-upon-filing” clauses are held to violate public policy and therefore are unenforceable as a matter of law. See, e.g., In re W.R. Grace & Co., 475 B.R. 34, 153 (D. Del. 2012). They are generally unenforceable under 11 U.S.C. § 365(e).


57 Nostas Assoc. v. Costich (In re Klein Sleep Prods., Inc.), 78 F.3d 18 (2d. Cir. 1996).


62 See, e.g., In re Automationsolutions Int’l, LLC, 274 B.R. 527 (Bankr. N.D. Cal. 2002). The probable result of cases like Automationsolutions is development of a new comfort provision in the sale order: a finding of fact that all findings and provisions of the order address matters that were necessarily determined in the sale. In any event, the practice of including these broad, insulating provisions in the sale order is likely to continue.


64 See generally 5 COLLIER ON BANKRUPTCY § 553.01; Bohack Corp. v. Borden, Inc., 599 F.2d 1160, 1164 (2d Cir. 1979).
In re B & L Oil Co., 782 F.2d 155, 157 (10th Cir. 1986) (“In bankruptcy, both recoupment and setoff are sometimes invoked as exceptions to the rule that all unsecured creditors of a bankrupt stand on equal footing for satisfaction. Recoupment or setoff sometimes allows particular creditors preference over others.”). See also Lee v. Schweiker, 739 F.2d 870, 875 (3d Cir. 1984) (“Setoff, in effect, elevates an unsecured claim to secured status, to the extent that the debtor has a mutual, pre-petition claim against the creditor.”); CDI Trust v. U.S. Elecs., Inc. (In re Commc’ns Dynamics, Inc.), 382 B.R. 219, 228 (Bankr. D. Del. 2008); Express Freight Lines, Inc. v. Kelly (In re Express Freight Lines, Inc.), 130 B.R. 288, 291 (Bankr. E.D. Wis. 1991) (noting that “Bankruptcy Courts have consistently allowed setoff even though this right is ‘at odds with the fundamental bankruptcy principle of equality of distribution among creditors because it permits a creditor to obtain full satisfaction of a debt by extinguishing an equal amount of the creditor’s obligation to the debtor.’ Courts have allowed this right because without it, it would be unfair to require a creditor to pay in full what is owed to the debtor only to receive a portion, if that, of its claim against the debtor.”) (citation omitted).

See 5 COLLIER ON BANKRUPTCY § 553.01; In re Pub. Serv. Co. of New Hampshire, 884 F.2d 11, 14 (1st Cir. 1989); Davidovich v. Welton (In re Davidovich), 901 F.2d 1533, 1537 (10th Cir. 1990).


70 726 F.2d 93 (3d Cir. 1984).


Cooper-Jarrett, 726 F.2d at 96.

11 U.S.C. § 101(12); Pennsylvania Dep’t of Pub. Welfare v. Davenport, 495 U.S. 553, 558 (1990); Gerth, 991 F.2d at 1433; Braniff Airways, Inc. v. Exxon Co., U.S.A., 814 F.2d 1030, 1036 (5th Cir. 1987); Camelback Hosp., Inc. v. Buckenmaier (In re Buckenmaier), 127 B.R. 233, 238 (B.A.P. 9th Cir. 1991). See also U.S. Agric. Stabilization & Conservation Serv., 991 F.2d at 1433. See generally 5 COLLIER ON BANKRUPTCY § 553.02(2) (“As a general rule, an obligation
that would constitute a proper prepetition claim under section 553 if asserted by a creditor will likewise constitute a proper prepetition debt if asserted by the debtor.”).


79 Braniff Airways, 814 F.2d at 1039.


81 In re United Sciences of Am., Inc., 893 F.2d 720, 723 (5th Cir. 1990); In re Elcona Homes Corp., 863 F.2d 483, 486 (7th Cir. 1988).

82 See, e.g., Depositors Trust Co. of Augusta v. Frati Enters., Inc., 590 F.2d 377, 379 (1st Cir. 1979); In re Vehm Eng’g Corp., 521 F.2d 186, 191 (9th Cir. 1975).


84 Kitaeff, 140 B.R. at 614.

85 Id. See generally 5 COLLIERS ON BANKRUPTCY § 553.02(3)(c) (“As a general rule, the concept of capacity requires that each party owe the other something in his or her own name, and not as a fiduciary. For example, if A in his individual capacity owes $100 to B, but B owes $50 to A in A’s capacity as trustee of a trust, or as a fiduciary or agent for some other party, the obligations are not mutual because they are not owed between the parties acting in the same “capacity.”).}


93 Newton v. Beneficial Fin. Co. (In re Diplomat Elec., Inc.), 558 F.2d 731, 732 (5th Cir. 1977); Riggs v. Gov’t Employees Fin. Corp., 623 F.2d 68, 74-75 (9th Cir. 1980).


96 United States v. Irving Trust Co. (In re Clayton Magazines), 77 F.2d 852, 853 (2d Cir. 1935) (where applicable statute of limitations had run on debt, debt was not valid and setoff could not be taken in bankruptcy).


98 Bird v. Carl’s Grocery Co. (In re NWFX), 864 F.2d 593, 595 (8th Cir. 1989); Boston & Maine Corp. v. Chicago Pac. Corp., 785 F.2d 562, 566 (7th Cir. 1986).


100 Id. at 19.

101 Gray, 85 U.S. at 632-33 (even though rule of setoff in Pennsylvania did not require mutuality, mutuality is required in bankruptcy and, therefore, setoff would not be permitted).
generally 5 COLLIER ON BANKRUPTCY § 553.05.

103 See 11 U.S.C § 553(a) (“Except as otherwise provided in this section and in sections 362 and
363 of this title, this title does not affect any right of [setoff]”); Citizens Bank of Maryland, 516
U.S. at 19; D & B Auto Parts, Inc. v. Freeborn (In re Freeborn), 100 B.R. 474, 474 (Bankr. E.D.
Mo. 1989).

1980); Griffith v. Sw. Bell Tel. Co. (In re Voight), 24 B.R. 983, 986 (Bankr. N.D. Tex. 1982); In

105 In re Corland Corp., 967 F.2d 1069, 1077 (5th Cir. 1992).

106 Bohack, 599 F.2d at 1168; Waste Mgmt. of Tenn., Inc. v. Barry Parker’s, Inc. (In re Barry
Parker’s, Inc.), 33 B.R. 115, 117 (M.D. Tenn. 1983).

107 Soares v. Brockton Credit Union (In re Soares), 107 F.3d 969, 976 (1st Cir. 1997);
Constitution Bank v. Tubbs, 68 F.3d 685, 692-93 (3d Cir. 1995); Parker v. Bain, 68 F.3d 1131,
1138 (9th Cir. 1995); Franklin Sav. Ass’n v. Office of Thrift Supervision, 31 F.3d 1020, 1022
(10th Cir. 1994); Rexnord Holdings, Inc. v. Bidermann, 21 F.3d 522, 527-28 (2d Cir. 1994);
Albany Partners, Ltd. v. Westbrook (In re Albany Partners, Ltd.), 749 F.2d 670, 675 (11th Cir.
1984); Matthews v. Rose, 739 F.2d 249, 251 (7th Cir. 1984)).

108 Bronson v. United States, 46 F.3d 1575, 1578-79 (Fed. Cir. 1995); Picco v. Global Marine
Drilling Co., 900 F.2d 846, 850 (5th Cir. 1999); Easley v. Pettibone Mich. Corp., 990 F.2d 905,
911 (6th Cir. 1993); In re Williams, 257 B.R. 297, 300-01 (Bankr. W.D. Mo. 2001)).


616 F.2d 83, 85 (3d Cir. 1980); Blanton, 105 B.R. at 337.

See generally 5 COLLIER ON BANKRUPTCY § 553.06.

112 United States v. Fleet Bank (In re Calore Exp. Co., Inc.), 288 F.3d 22, 39-40 (1st Cir. 2002);
Suncrete Corp. v. Glusman (In re Suncrete Corp.), 100 B.R. 102, 103-04 (Bankr. M.D. Fla.
1989); Weems v. United States (In re Custom Ctr., Inc.), 163 B.R. 309, 317 (Bankr. E.D. Tenn.
1994); In re South Park Care Assoc., 203 B.R. 445, 447 n.1 (Bankr. W.D. Mo. 1996). See also
In re Indus. Assoc., Inc., 155 F. Supp. 866, 870 (E.D. Penn. 1957); In re Ne. Int’l Airways, Inc.,

(Bankr. S.D. Fla. 1990), aff’d, 155 B.R. 245 (D.S.D. Fla. 1992), aff’d without op., 985 F.2d 579
114 See, e.g., In re United States v. Myers (In re Myers), 362 F.3d 667, 672 (10th Cir. 2004); Express Freight Lines, 130 B.R. at 290.

115 Davidovich, 901 F.2d at 1537; Turner v. United States (In re G.S. Omni Corp.), 835 F.2d 1317, 1318-19 (10th Cir. 1987).


120 11 U.S.C. §§ 544(b), 548.


Id.

Id.

Id.

In re Madigan, 270 B.R. 749, 756 (B.A.P. 9th Cir. 2001).

Dewey Freight Sys. Inc., 31 F.3d at 622 (quoting In re Univ. Med. Ctr., 973 F.2d 1065, 1081 (3d Cir. 1992)).

In re Photo Mech. Servs., Inc., 179 B.R. 604, 613 (Bankr. D. Minn. 1995) (“The fact that a contract exists between the parties does not automatically enable the creditor to avail itself of recoupment.”).

See, e.g., Westinghouse Credit Corp. v. D’urso, 278 F.3d 138, 147 (2d Cir. 2002); Univ. Med. Ctr., 973 F.2d at 1081; In re Gasmark Ltd., 193 F.3d 371, 374-75 (5th Cir. 1999); Dewey Freight Sys. Inc., 31 F.3d at 622; In re Peterson Distrib., Inc., 82 F.3d 956, 961 (10th Cir. 1996).

Newberry, 95 F.3d at 1402 (citing Moore v. New York Cotton Exch., 270 U.S. 593 (1926)).

In re Madigan, 270 B.R. 749, 754 (B.A.P. 9th Cir. 2001).


Id. at 141-42.


Id.


Id.

293 U.S. 328, 333 (1934).


In re Unicom Comput. Corp., 13 F.3d 321, 324-25 (9th Cir. 1994); In re Howard’s Appliance Corp., 874 F.2d 88, 93 (2d Cir. 1989); Vineyard v. McKenzie (In re Quality Holstein Leasing), 752 F.2d 1009, 1012 (5th Cir. 1985).


See, e.g., In re Golden Triangle Capital, Inc., 171 B.R 79, 81-83 (9th Cir. BAP 1994).

See also United States v. Durham Lumber Co., 363 U.S. 522, 523-27 (1960) (applying North Carolina law); Keenan Pipe & Supply Co. v. Shields, 241 F.2d 486, 489-91 (9th Cir. 1956);
157 Golden Triangle, 171 B.R. at 82.

158 XL/Datacomp v. Wilson (In re Omegas Grp., Inc.), 16 F.3d 1443, 1452 (6th Cir. 1994) (stating: “Constructive trusts are anathema to the equities of bankruptcy since they take from the estate, and thus directly from competing creditors, not from the offending debtor”).

159 Id. at 1451. See also 11 U.S.C. §§ 523(a), 541(d)(2009).


162 See, e.g., Ga. Pac. Corp. v. Sigma Serv. Corp., 712 F.2d 962 (5th Cir. 1983) (joint check agreement that was revocable at will by any party and contained no specific requirements held insufficient to establish a constructive trust).


164 Golden Triangle, 171 B.R. at 83 (explicitly stating debtor was a conduit); In re Mastercraft Metals, Inc., 114 B.R. 183, 187 (Bankr. W.D. Mo. 1990) (explicit); Temp-Way Corp., 80 B.R. 699 (implicit); Mid Atl. Supply, Inc., 790 F.2d 1121 (where the joint check in question was issued pursuant to a written agreement and where the amount of the check was admittedly only intended to cover the supplier’s materials (and the debtor had no costs added on), the court imposed a constructive trust on the proceeds despite the failure of the joint check agreement to ever identify a specific res) (implying debtor was a conduit). See also In re Davidson Lumber Sales, Inc., 66 F.3d 1560 (10th Cir. 1995).

165 In re Anthony P. Buono, 119 B.R. 498 (Bankr. W.D. Pa. 1990) (stating that when a material supplier, after receiving endorsed checks, was to refund debtor any balances owed to debtor, then the parties had an independent interest in the check, thereby making it “property of the estate”).

166 In re Network 90 Degrees, Inc., 98 B.R. 821 (Bankr. N.D. Ill. 1989) (stating that when a debtor had joint checks routinely forwarded directly to suppliers, that were given power of attorney to sign same for debtor, the court found a constructive trust was warranted).

167 In re Sun Belt Elec. Constructors, Inc., 56 B.R. 686 (Bankr. N.D. Ga. 1986) (stating that since the funds were not equitably those of the debtor, neither the debtor nor the unsecured creditors of the debtor’s estate would benefit from the proposed rejection).


173 The Code recognizes offset claims and essentially treats them like secured claims. 11 U.S.C. § 553.


180 See In re Lockard, 884 F.2d 1171 (9th Cir. 1989).

181 See, e.g., Hunt Constr. Grp, Inc. v Nat’l Wrecking Corp., 587 F.3d 1119 (D.C. Cir. 2009) (requiring reasonable notice to the surety and a declaration of default); Nova Cas. Co. v. Turner Constr. Co., 335 S.W.3d 698 (Tex. App. 2011) (requiring owner to only notify the surety of the contractor’s default without having to terminate the bonded contract); Walter Concrete Constr. Corp. v. Lederle Labs, 788 N.E.2d 609 (N.Y. 2003) (rejecting the notice requirement outside of pleadings, as well as the declaration of default requirement).

182 See, e.g., § 2.5 of AIA Document A201 (2017 ed.); § 3.5 of AIA Document A401 (2017 ed.).


See 11 U.S.C. §362(b)(3) (allowing creditors to file liens for the purpose of continuing the perfection of an existing lien). See also Concrete Structures, 261 B.R. at 641 (“Mechanics’ lienholders have always been exempt from the automatic stay provision of §362 if some action is required to perfect their interest in the property.” (citing 11 U.S.C. § 362(b)(3)); In re Bain, 52 B.R. 58, 60 (W.D. Va. 1985) (“So long as state law permits a relation-back type of perfection which would defeat an intervening lien creditor, §546(b) allows the creditor to perfect and allows the relation-back feature to defeat the rights of the bankruptcy trustee.”); In re Linear Elec. Co., 852 F.3d 313, 322 (3d Cir. 2017).

See In re Richardson Builders, Inc., 123 B.R. 736, 739 (Bankr. W.D. Va. 1990) (“[I]n Virginia, the recording of a memorandum of lien does not violate the stay imposed by section 362(a), while the filing or prosecution of an enforcement action under Va. Code § 43-22 does do so.”); See also In re Linear Elec. Co., 852 F.3d at 322.

See 11 U.S.C. §§ 108(c), 546(b)(2); see also Concrete Structures, 261 B.R. at 642 (referring to the extension of time provided by Code section 108(c)).


Although probably not relevant in most construction cases, the reference look-back period where the transferee is an “insider,” as defined in the Code, is one year. 11 U.S.C. § 547(b)(4)(B). The presumption of insolvency, however, goes back only 90 days pre-petition, regardless of insider status. 11 U.S.C. § 547(f).


See, e.g., In re Nucorp Energy, Inc., 902 F.2d. 729 (9th Cir. 1990).

See 11 U.S.C. §§ 545, 547(c)(6) (discussing the avoidance powers related to statutory liens).

See, e.g., In re Globe Mfg. Corp., 567 F.3d 1291, 1297 (11th Cir. 2009) (finding that “even if [the creditor] had perfected a lien against [the debtor’s] plant, there would have been no equity to which the lien could attach”). Perfected mechanic’s liens who can be at risk when, e.g., the bankruptcy court approves (1) post-petition debtor-in-possession financing that provides for lender “priming liens” on all estate assets and/or “superpriority” claim status over administrative claims pursuant to Code section 364(c) and/or 364(d), or (2) the sale of estate property free and clear of all liens, including mechanic’s liens, pursuant to Code section 363(f).

Coplay Cement Co. v. Willis & Paul Grp., 983 F.2d 1435 (7th Cir. 1993) (recognizing owner’s common law right to set off damages against contractor sustained on one project against a stop payment notice issued by a subcontractor of same contractor on another project); Buck’s Run Enters., Inc. v. MAPP Constr., Inc., 808 So.2d 428, 430 (La. App. 2001) (recognizing a contractor’s common law set off of moneys owed to a subcontractor on one project from moneys due to breaches on another project); Algemon Blair, Inc. v. Nat’l Sur. Corp., 151 S.E.2d 724 (Ga. 1966) (court upheld right of contractor to deduct from final payment any sums due contractor from subcontractor on other subcontracts: cf. Howell v. Medler, 2 N.W. 911 (Mich.
(court held that damages resulting from failure of contractor to perform one of two separate contracts could be offset only against the amount found due under the contract upon which such damages arose).

216 Beane Plumbing & Heating Co. v. D-X Sunray Oil Co., 92 N.W.2d 638 (Iowa 1958.)