SOUTHWEST BUSINESS & CONSTRUCTION CREDIT VIRTUAL CONFERENCE

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My Customer Filed Bankruptcy. Now What?

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INTRODUCTION

The onslaught of bankruptcy filings forecasted as a result of the COVID-19 Global Pandemic has not happened—yet. However, the impact the Coronavirus has had on the U.S. economy merits a good working knowledge of creditor rights in bankruptcy.

Bankruptcy can be an evil word to credit suppliers creating all kinds of fear and concern regarding obtaining payment, the bankruptcy process and keeping what you already received from the debtor. This seminar discusses how a creditor's rights can be impacted by the bankruptcy of a contractor or owner, and what can be done to minimize your loss.

A. Property of the Estate

Upon the filing of a bankruptcy petition, an "estate" is created consisting of all property and property interests of the debtor. 11 U.S.C. § 541 defines "property of the estate." The term is so broad as to include within its scope almost every conceivable interest of the debtor in property. The statutes' legislative history and case law support a broad interpretation of its scope. Property rights in the assets of a bankruptcy estate are determined ultimately by state law. Property of the estate includes a wide variety of interests including the debtor's equipment, inventory, accounts receivables, intellectual property rights, tort claims, vehicles, real property, contract rights, etc. As a result, an executory construction contract may be property of the bankruptcy estate.

While the scope of §541 is very broad, there are certain assets that do not become property of the bankruptcy estate. For instance, where a contractor opened a bank account in the name of the subcontractor with the intent of using the deposits into the account for payment of the subcontractor's materialmen, such funds would not become part of the subcontractor's bankruptcy estate. Similarly, where a general contractor entered into separate agreements to make payments directly to the material suppliers of a debtor subcontractor the court found that the payments did not involve property of the estate.

Another method through which contractors may seek to avoid payments becoming property of somebody's future bankruptcy estate is to require payment through joint checks. In general, the courts have found that funds paid in a joint check payable to a debtor and a supplier, subcontractor/general contractor do not constitute property of the estate. Typically, the courts look at the intent of the parties in entering into a joint check arrangement and find that the debtor was a mere conduit for the funds and never retained an interest in the funds or that the funds were earmarked for payment of a third party.

In certain situations, a debtor's bankruptcy estate will not include property that is held in trust for another. An example is the case of *Mars-Winn Co. v. Giberson Elec*. In *Mars-Winn,* 103 F.3d 584, the general contractor and a subcontractor established an express trust within the context of the subcontract which provided that the various laborers and materialmen were to be treated as beneficiaries. The court in *Mars-Winn* held that the trust arrangements had been properly created under Missouri law, and that the funds put in the trust were earmarked for completion of subcontract work and thus were not property of the estate.

I. IMPACT OF BANKRUPTCY FILING

A. Automatic Stay

Congress enacted Title 11 of the United States Code to allow persons or entities to seek relief from their debts by filing a bankruptcy petition. Individuals, assuming they meet the filing requirements, can file a bankruptcy petition under Chapter 7 (liquidation), Chapter 13 (wage earner) or Chapter 11 (reorganization) of the Bankruptcy Code. Entities, such as corporations and limited liability companies are eligible to file a petition under either Chapter 7 or Chapter 11 of the Bankruptcy Code. Fairly new is Chapter 11, Subchapter V, Small Business Reorganization and extended by the American Rescue Plan.

Immediately upon the filing of a bankruptcy petition, the "automatic stay" arises by virtue of 11 U.S.C. § 362. Section 362(a) lists acts which violate the automatic stay:

(1) commencement or continuation of any legal proceedings against the debtor;

(2) enforcement against the debtor or any property of the estate of a judgment obtained before the commencement of the debtor's case [§ 362(a)(2)];

(3) any act to obtain possession of or to exercise control over property of the debtor's estate [§ 362(a)(3)];

(4) any act to create, perfect, or enforce any lien against property of the estate [§ 362(a)(4)];

(5) any act to create, perfect, or enforce any lien against property of the estate to the extent such lien secures a claim that arose before the commencement of debtor's case [§ 362(a)(5)];

(6) any act to collect, assess, or recover a claim against the debtor, which arose before the commencement of the debtor's case [§ 362(a)(6)];

(7) any act to setoff any debt owing to the debtor before the commencement of debtor's case [§ 362(a)(7)];

The mere filing of a bankruptcy petition is not an act of default and cannot be the basis of the termination of a construction or supply contract.

B. Notice of Bankruptcy Filing

Within seven to ten days after the filing of a bankruptcy petition, the Bankruptcy Court mails to creditors a Notice of Bankruptcy Case, Meeting of Creditors and Deadlines (the "341

Notice"), which contains vital information about the debtor and a creditor's ability to obtain payment.

First, the 341 Notice will advise of the date, time, and place of the initial meeting of creditors required by 11 U.S.C. § 341. At the initial meeting of creditors, the debtor and/or the debtor's representative must appear and answer, under oath, certain questions regarding the debtor's bankruptcy filing and schedules. Creditors are afforded a limited opportunity to question the debtor. This is a key right of creditors because oftentimes the debtor and its counsel are ill prepared and sworn testimony can be elicited from the debtor, which improves the creditor's chances for payment.

Secondly, the 341 Notice may also set a deadline by which creditors are required to file a Proof of Claim. Proofs of Claim are discussed below; however, if a Proof of Claim is not filed by the deadline established by the Bankruptcy Court, a creditor has dramatically reduced the likelihood that it will receive any payment from the debtor.

Thirdly, the 341 Notice establishes the deadline to file a Non-Dischargeability Complaint pursuant to 11 U.S.C. §§ 523 and 727. A Non-Dischargeability Complaint is discussed below; however, the deadline should be calendared by the creditor so a decision can be made well in advance of the deadline whether there is a basis to have the creditor's debt declared non-dischargeable.

C. Executory Contracts

Section 365 provides the debtor-in-possession or trustee an opportunity to assume or reject executory contracts and unexpired leases. The Bankruptcy Code does not contain a definition of the term "executory contract," but most courts (including courts in the Ninth Circuit) apply the definition set forth by Vern Countryman's seminal article, *Executory Contracts in Bankruptcy: Part I*. There, Countryman defines an executory contract as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Thus, for a contract to be considered executory, the performance remaining on it generally must be both material and bilateral.

A construction contract may be an executory contract where a contractor has yet to complete its work and the owner has yet to make payment in full. The mere filing of a bankruptcy is not an act of default under a construction or supply contract and cannot be the sole basis of the termination of the contract. If, on the other hand, the construction contract between the parties has already been terminated prior to the filing of the bankruptcy petition, the contract will not be deemed executory.

Section 365 provides certain protections for both parties to an executory construction contract. For example, it provides the debtor an opportunity to assume the contract, or even to assume and then assign the contract to another party, provided that the debtor or the assignee can meet certain requirements (which generally include curing, or agreeing to cure, existing monetary defaults under the contract). For obvious reasons, the debtor is only likely to assume contracts that the debtor believes will be profitable. The owner, on the other hand, may seek to have the contract classified as non-executory or rejected quickly if the owner desires to proceed with having someone else complete the contract, potentially at a lower price.

The debtor may also choose to reject the executory contract. Rejection of the contract is treated as a pre-petition breach, entitling the non-breaching party to a general unsecured claim for damages related to the contract's rejection. Non-residential real property leases where the debtor is lessee must be assumed within 120 days of the petition date unless an extension is granted by the court. With other types of construction contracts and leases (such as equipment leases) debtors are not required to assume or reject until plan confirmation in cases under Chapters 9, 11, 12 or 13. In Chapter 7 liquidation cases, on the other hand, most contracts or leases are deemed rejected if they are not assumed within 60 days, or within such additional time as the court may fix.

Pending the debtor's decision to either assume the contract or reject the executory contract, the non-debtor party to the contract still is obligated to perform under the contract. The court in *In re El Paso Refinery, LP*, 196 B.R. 58, found that "until a court has affirmatively authorized rejection, the non-debtor party is not free to ignore the terms of the contract, and must continue to perform . . . additionally, the code places an independent duty on the non-debtor to continue the performance of an executory contract until it is assumed or rejected. Until an executory contract has been assumed or rejected, the code relieves the debtor of his duty to perform." Thus, while the debtor may be in default under a construction contract, a supply agreement, or a subcontract, the other party is generally still obligated to perform or risk sanctions for having violated the automatic stay. With that in mind, it is advisable that the non-debtor party quickly either: (1) move for relief from the automatic stay to terminate the contract or to withhold performance under the contract; or (2) move to compel the debtor to assume or reject the contract within a shorter period of time.

D. <u>Cash Collateral</u>

Frequently, both the debtor and a third party will have an interest in property of the bankruptcy estate, together with proceeds, rents and profits stemming from that property. For instance, a secured creditor may have a security interest in accounts receivable or equipment. To the extent that the accounts receivables are collected, or the equipment is sold and generates cash, such cash may be classified as "cash collateral." Upon filing of the bankruptcy petition, a debtor may use cash collateral only with consent of the creditor or court authorization.

II. <u>RECLAMATION</u>

Under non-bankruptcy law, a creditor who sold goods on credit while the debtor is insolvent may "reclaim" the goods upon a demand made within ten (10) days after receipt of the goods by the buyer (A.R.S. § 47-2702). This right granted under Arizona's version of the Uniform Commercial Code has a short fuse of 10 days for the seller to make demand to reclaim the goods sold. The Bankruptcy Code extends this 10-day deadline. 11 U.S.C. § 546(c) extends the deadline to reclaim goods sold on credit from 10 days to 45 days after receipt of such goods or (if the 45-day period expires after the bankruptcy filing) within 20 days after the debtor's bankruptcy filing. Notwithstanding whether the seller holds any reclamation rights, a seller is also entitled to an administrative expense claim for the value of goods sold within 20 days before the debtor's bankruptcy if the goods were sold in the ordinary course of the debtor's business.

Reclamation can be a powerful tool for a seller of goods to a bankrupt contractor. First, the reclamation reach back period has been expanded from 10 days under state law, to 45 days, under the Bankruptcy Code and sellers now have 20 days instead of 10 days after the contractor's bankruptcy filing to reclaim goods.

Reclamation is accomplished by providing a written reclamation demand to the debtor which specifically identifies the goods delivered to the debtor which are sought to be reclaimed.

Reclamation is a right that must be immediately exercised upon a debtor's bankruptcy filing. Failure to seek reclamation within the allotted time period waives the creditor's reclamation claim. A creditor who has the ability to "reclaim" the goods elevates its priority for payment in the debtor's bankruptcy case.

III. PREFERENCES

A preference is a pre-petition transfer, usually a payment, which allows that creditor to receive more than other creditors in the debtor's bankruptcy case. Since the payment violates the Bankruptcy Code's fair and equal treatment of creditors, certain preferences or transfers are avoidable to prevent one creditor, who happens to be the pre-petition squeaky wheel, from obtaining a benefit to the detriment of other creditors who work with the debtor until the bankruptcy filing. The trustee in a Chapter 7 or Chapter 13 bankruptcy case and the debtor-in-possession in a Chapter 11 case are granted the power to look back 90 days before the bankruptcy was filed (one year for insiders) and recover those payments or transfers of the debtor's property which are preferential. This avoidance power means that the trustee or debtor can force the creditor who received a payment from the debtor before bankruptcy to repay money to the bankruptcy estate. This repayment may be compelled notwithstanding the fact that the creditor was fully entitled to have its debt paid at the time the creditor received the funds.

IV. PREFERENCE PAYMENTS -- PROTECTING YOUR MONEY FROM A BANKRUPTCY NIGHTMARE

A. Introduction

Under certain circumstances, payments made by a project owner to a contractor within 90 days before the owner files bankruptcy may be recaptured by the owner as a "preference payment." This repayment may be compelled despite the fact that the contractor was fully entitled to the money at the time payment was made. The purpose of this preference power is to prevent a debtor from "preferring" one creditor over another, thereby insuring a fair distribution among all creditors. The trustee in a Chapter 7 or Chapter 13 bankruptcy case and the debtor-in-possession in a Chapter 11 case are granted the power to look back 90 days before the bankruptcy was filed (one year for insiders) and recover those payments or transfers of the debtor's property which are preferential. This avoidance power means that the trustee or debtor can force the creditor who received a payment from the debtor before bankruptcy to repay money to the bankruptcy estate. This repayment may be compelled notwithstanding the fact that the creditor was fully entitled to have its debt repaid at the time the creditor received the payment.

B. Preference Elements.

Specifically, the bankruptcy trustee may avoid a transfer when all of the following six (6) factors exist:

1. A transfer of property of the debtor;
2. To or for the benefit of a creditor;
3. For or on account of an antecedent (prior) debt;
4. While the debtor was insolvent;
5. Within 90 days preceding the bankruptcy case (one year for an insider);
6. Enabling the creditor who received the transfer to be paid more than the creditor would have received if the debtor's assets were liquidated pursuant to Chapter 7.

Each of these specific preference elements are further discussed below.

1. Transfer of debtor's property. Under the Bankruptcy Code "transfer" has a broad meaning and includes any voluntary or involuntary transfer of an interest in "property" (also broadly defined) of the debtor. A transfer of an interest in property (i.e., obtaining a security interest in property) is sufficient to trigger a preference. It is not necessary for actual physical possession or title to be transferred from the debtor to a creditor. Conversely, if no property interest is transferred, then it is not an avoidable preferential transfer. Consequently, if a non-bankrupt third party makes the transfer, it is not a preference unless the third party receives a security interest in the debtor's property in return for the payment.

a. Involuntary transfer. Involuntary transfers can be preferential transfers if the six factors exist. Typical examples of an involuntary transfer are attachment, garnishment, execution, judgment lien or most other types of collection activities, provided these occur within the 90-day preference period. If a creditor is merely enforcing a pre-existing lien or security interest which was perfected prior to the 90 days, the creditor's enforcement will not be a preference unless the lien is otherwise avoidable by the trustee.

2**.** Transfer for the benefit of a creditor**.** For it to be a preference, you must be a creditor at the time of the transfer. Although the debtor's gift of $30,000 to the debtor's mother 30 days before bankruptcy is filed may be a fraudulent transfer, it is not a preference unless the debtor's mother was owed money at the time of transfer.

This provision is designed to prevent laundering of the debtor's payment. For example, if the debtor owes the creditor and gives the payment to a third party to pay to the creditor, it is nonetheless a preferential transfer despite the fact that the debtor did not pay the creditor directly. Because the payment is nonetheless for the benefit of the creditor, it can be set aside as a preference.

3**.** Transfer for or on account of an antecedent debt. The debt must be a prior or outstanding debt for which the debtor is legally bound to pay in order for the payment to constitute a preference. This will be discussed below regarding defenses to preference claims, however, by way of example, if the debtor ordered $30,000 worth of widgets from a creditor, the creditor sells the widgets on a C.O.D. basis, shipped the widgets and was paid $30,000 upon delivery, it would not constitute a preference because the $30,000 payment from the debtor was not on behalf of a prior debt.

4**.** Transfer while the debtor is insolvent**.** The test to determine whether a debtor was insolvent at the time the transfer was made is a "balance sheet insolvency" test meaning whether the fair value of the debtor's non-exempt property is less than the amount of the debtor's liabilities. Furthermore, the Bankruptcy Code presumes for preference purposes that the debtor was insolvent 90 days prior to the filing of the debtor's bankruptcy petition (11 U.S.C. § 547(f)). Although it is a rebuttable presumption, meaning that the creditor can prove the debtor was not insolvent, is a difficult presumption to rebut.

5. Transfers occurring within 90 days preceding the petition. Most creditors need only be concerned with payments or transfers received within 90 days prior to the date of the debtor's bankruptcy filing. However, for certain "insiders" the look-back period is one year. An "insider" is defined in the Bankruptcy Code as persons or entities that have a close blood, financial or control relationship with the debtor (11 U.S.C. § 101(31)); for an individual debtor it includes relatives within the third degree of consanguinity (11 U.S.C. § 101(45)); general partners of a partnership in which the debtor is a general partner as well as any corporation in which the debtor is an officer or director or controlling person; for a corporate debtor it includes all officers, directors and controlling persons.

6. Creditor must receive more than in a Chapter 7. The final element to constitute a preference requires the creditor receive a greater percentage of its claim than it would if the debtor was liquidated under Chapter 7. To perform this analysis the transfer is undone, and the transferred property added back to the debtor's estate and then compared to the liquidation payment to creditors in the same class as the creditor receiving payment. Generally, this greater percentage test is almost always satisfied with respect to unsecured creditors because they rarely receive 100% payment of their claims. However, if a creditor settled an account and received less than the full amount owed, despite receiving payment, it may nonetheless not be a preference if the creditor accepted the same or less than the creditor would receive in a Chapter 7.

C. When is the transfer made?

A transfer of the debtor's property is considered made when it becomes effective between the transferor debtor and transferee creditor. Transfers of personal property are perfected once the transferee is entitled to priority against a hypothetical subsequent judicial lien. 11 U.S.C. § 547(e)(1)(B). For example, cash is effective upon payment. A payment by check is effective upon the check being honored by the bank. Other transfers of property are effective upon perfection, i.e., filing a security interest with the Secretary of State's office for personal property or recording with the county recorder's office for real property. Such transfers even if previously accomplished are deemed effective upon perfection.

Since the perfection of many interests in property (filing a UCC Financing Statement, obtaining a lien on a vehicle's Certificate of Title, recording with the county recorder) frequently do not occur simultaneously but rather within a few days, the Bankruptcy Code provides a 30-day grace period for perfection. 11 U.S.C. § 547(e)(2). Consequently, if a transfer of an interest in the debtor's property is perfected within 30 days of the time it becomes effective between the debtor and creditor, the transfer will be considered to have taken place when it was effective and not when perfected. However, it is only a 30-day grace period and if for example a vehicle lien is perfected on day 31, it would be subject to preference attack by the trustee.

D. <u>Defenses to a Preference Claim</u>

All hope is not lost if you are the recipient of a payment or transfer of an interest in the debtor's property within the 90 days preceding the date of the debtor's bankruptcy filing. There are many defenses to a preference claim, including:

1. Substantially contemporaneous exchange for value;
2. Payments in the ordinary course of debtor's business and financial affairs;
3. Purchase money security interests;
4. Preferential transfers followed by new value;
5. Security interests in inventory and accounts receivable;
6. Valid statutory liens;
7. Domestic support obligations;
8. Payments of less than $600 in a primarily consumer case;
9. Payments of less than $7,575[1] in a primarily non-consumer case; and
10. Transfers made as part of an alternative repayment schedule created or approved by a non-profit budget or credit counseling agency.

The Small Business Reorganization Act of 2019 requires a trustee to use due diligence in commencing a preference claim taking into consideration reasonably knowable affirmative defenses.

These defenses and the elements necessary to satisfy the various defenses are set forth below.

1. <u>Substantially contemporaneous exchange for value</u>. As previously stated, to the extent $30,000 worth of widgets are ordered, shipped C.O.D., and paid for at the time of delivery, the payment is not a preference since $30,000 worth of widgets were supplied in

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[1] This exemption amount is adjusted every three-years, the most recent adjustment became effective April 1, 2022. For bankruptcies filed prior to April 1, 2022, the exemption amount is $6,825.

exchange for the contemporaneous payment of $30,000. This defense can also apply when goods are sold on open account where a supplier may be willing, even with an outstanding account receivable, to ship additional materials in exchange for a concomitant payment by the debtor for the new goods, but not for the outstanding account receivable.

2. Payments in the ordinary course of business. The second defense most readily utilized by suppliers is whether the debt was incurred during the ordinary course of business conducted between the debtor and creditor or according to the ordinary business terms. In order to establish an ordinary course of business, a creditor has to prove the payment received was ordinary as to the relationship between the creditor and the debtor (the subjective test, i.e. although terms were net 30, debtor always paid net 60), or prove that the method of payment was within common or ordinary practices accepted in the industry (the objective test, i.e. industry terms were net 60). The creditor can meet either of these tests.

For creditors selling on open account, upon the filing of bankruptcy, an aging report should be immediately run which reflects the date of each order, the date of shipment/receipt by the debtor, the date of payments received from the debtor as well the sales terms as stated in the credit application and invoices for the one (1) year period prior to the bankruptcy filing. With this information, an analysis can be performed as to the extent of any preference exposure the creditor may have. The creditor can use this information to prove either that the transfer was made in the ordinary course of business or that it was pursuant to industry custom, which in either event is a defense to a preference claim.

3. Purchase money security interests. If the debtor borrowed money which was used to purchase property in which the creditor retained a security interest and it was timely perfected (i.e., thirty days), it will not constitute a preference. For example, if the debtor buys a car financed by a bank which obtained a lien on the vehicle's Certificate of Title, then the debtor files bankruptcy on day 20 and the bank submits the application to the Department of Motor Vehicles for a lien on the certificate of title within the 30-day period it will not be a preference since it falls into the purchase money security interest exception to preference payments. The Bankruptcy Code prohibits the trustee from avoiding a purchase money security interest when: (a) the loan was pursuant to a written security interest agreement describing the collateral; (b) it is given by the secured creditor to the debtor to enable the debtor to acquire the property; (c) the debtor uses the proceeds of the loan to acquire the collateral and (d) the secured creditor perfects its interest within 30 days.

4. Subsequent new value defense. In this scenario the creditor gives "new value" defined as monies worth in goods, services, new credit, or lease but does not include an obligation substituted for an existing obligation in exchange for payment. In addition, new value must be unsecured. The subsequent new value defense permits the creditor to retain a preference payment if after receipt of the preference the creditor gave new value to or for the benefit of the debtor. If the new value has been repaid, the repayment itself may be avoided. For example, if the supplier received payments of $150,000 within 90 days before the debtor's bankruptcy filing yet shipped $200,000 worth of materials during that same time period, it would not be a preference. The reason is the debtor's estate was not diminished by the preferential payments received by the supplier.

5. Setoff. Pursuant to 11 U.S.C. 547(c)(4), unsecured advances occurring after a preferential payment has been made may be setoff against the amounts the creditor will have to return to the trustee. Consequently, if a debtor makes a payment and the creditor advances additional supplies on open account, any subsequent advances are entitled to be setoff against any claim that the payment constituted a preference.

6. Security interests in inventory and accounts receivable. Where a creditor has a "floating lien" (a lien which attaches to collateral routinely sold, i.e., inventory and accounts receivables), a defense to a preference claim is that the payment or transfer of an interest in property did not allow the creditor to improve its position during the preference period. To apply the defense, the value of the creditor's collateral on the petition date is compared to the value at the beginning of the preference period. Transfers during the preference period are only avoidable if the value of the collateral on the petition date is higher than the value of the collateral 90 days prior to the bankruptcy filing.

7. Valid statutory liens. Certain statutory liens (i.e., mechanic's liens) the recording of which during the preference period would ordinarily be considered a preference are specifically excluded as a preference.

8. Domestic support obligations. Payments received for child support, alimony or maintenance defined under 11 U.S.C. § 101(14)(a) do not constitute preferences.

9. Consumer payments less than $600. Payments by a consumer debtor of less than $600 cannot be avoided as a preference by the trustee. The limitation is not limited to payments of consumer debts. Consequently, if a consumer paid a $500 business debt, it would not be considered a preference. If a consumer debtor pays its creditor $599, it will not be a preference; however, if the payment is $600, the entire payment is avoidable as a preference.

10. Non-consumer payments of less than $7,575[2]. Payments of less than $7,575 by a debtor whose debts are not primarily consumer debts are not preferences.

11. Jurisdiction and venue for preference litigation. Additionally, in a change made by the SBRA of 2019, if the amount of the payment is less than $15,000 if a consumer debt or $25,000 if a non-consumer debt and the creditor is not an insider, any preference claim must be brought in the bankruptcy court for the district where the creditor resides. (28 U.S.C. § 1409). Any preference claim must be commenced prior to the earlier of: (1) the later of (a) two years after the bankruptcy filing and (b) one year after appointment of a trustee; or (2) the time the case is closed or dismissed.

Some of the most common of these defenses, as applied to issues impacting various parties to a construction project or projects, are outlined in greater detail as follows:

E. Release of Mechanic's Lien as "Contemporaneous Exchange for New Value" Defense to a Preference Claim

[2] *See* footnote 1.

The release of a mechanic's lien may constitute new value sufficient to protect the payment to the contractor from preference attack. More simply put, the question is whether the value given in the form of a lien release leaves the owner's bankruptcy estate undepleted by the payment made to the contractor. For many years it was generally held that the release of a lien, whatever the value of the lien might be, constituted sufficient new value to invoke the preference defense. Unfortunately, this bright line rule has been rejected by the majority of courts, including the Ninth Circuit Court of Appeals, whose decisions control the law in Arizona.

The "contemporaneous exchange of new value" defense will not be available unless the contractor can establish to the satisfaction of the bankruptcy court that the value of the lien released equals or exceeds the payment received by the contractor. This showing will likely be extraordinarily difficult, if not impossible to make. For example, the contractor would need to learn the current balance of the construction loan at the time of the payment, and also determine the value of the construction improvements completed through the date of the payment. If the land plus improvements constructed to date were not worth more than the loan balance, there would be no "new value" defense because there was no "equity" to which the lien could have attached. If the lien rights have some value, the extent of the value may be a partial defense to the preference claim. For example, if the mechanic's lien could encumber $10,000 of equity in the property, and the payment made by the general contractor to the supplier was in the amount of $50,000, then only $40,000 of the payment would be preferential and subject to recovery by the bankrupt owner.

A rarely asserted version of this defense is the claim that the lien release given by the contractor, while not having released a valuable mechanic's lien, did free up substantial contract proceeds to be paid to a debtor/general contractor. Thus, the payment did not "diminish" the general contractor's bankruptcy estate.

F. Ordinary Course of Business Defense

An entirely separate protection from preference attack exists in the ordinary course of business exception. The purpose of this exception is to leave undisturbed normal financial transactions.

Bankruptcy law provides that a trustee may avoid certain preferential transfers made to non-insider creditors within the 90 days preceding filing of the debtor's bankruptcy petition. The purpose of the preference law is to try to prevent a prepetition rush to the courthouse by creditors and to allow for unsecured creditors to share in the debtor's assets on a pro-rata basis. Bankruptcy law also provides for certain defenses to preference actions brought by a trustee against a creditor including the ordinary course defense. The requirements for an ordinary course defense are: The creditor need only to demonstrate either that the transfer was made in the ordinary course of business between the parties or that the transfer was made according to ordinary business terms. An example of how this might affect sureties is as follows:

Debtor, Buildem Co. ("Buildem"), is a construction company working on construction of an apartment building (the "Project"). Buildem makes three payments of $50,000 a piece to its longtime lumber supplier, Lumberjacks, within 90 days of Buildem filing bankruptcy. The debt to Lumberjacks was incurred in Buildem's ordinary course of business and the payments were each made within 85 days of invoice, which was the ordinary course between Buildem and Lumberjacks. However, the normal payments terms in the lumber industry are payments to occur within 35 – 45 days of invoice.

Upon the filing of Buildem's bankruptcy, the trustee sues Lumberjacks for the $150,000 paid during the 90-day period. Lumberjacks has a potentially good ordinary course defense since Lumberjacks can claim the payments were received within 85 days, which is in ordinary course of business between the parties even if outside the ordinary business terms in the industry.

The "ordinary course" exception can be difficult to invoke in the construction industry. Although some construction industry relationships are long term and repetitive, thereby lending themselves to establishment of an "ordinary course of conduct", (e.g., equipment rental to a given account or material supplied to a particular trade subcontractor) many other transactions are unpredictable, sporadic, or transient (e.g., irregular payment of construction draws on a particular project, purchase of construction supplies from a particular source at infrequent intervals, use of numerous, different subcontractors in the same trade over the course of time due to competitive bidding).

It is clear from the language of the Bankruptcy Code that the practice of the owner and the contractor in their past dealings shall be the primary consideration in determining whether a payment to the contractor was ordinary. This is sometimes referred to as a "subjective" test. However, an alternative basis is to demonstrate that the manner and timing of the allegedly preferential payments were consistent with the ordinary course of business in the construction industry. This is sometimes referred to as an "objective" test.

Essentially, either test requires the contractor to prove the ordinary nature of the payment transactions with the project owner. Usually there is little or nothing ordinary about these transactions within the commonly understood meaning of that term, but every attempt should be made to employ this defense.

G. Subsequent New Value Defense

Another preference exception that may be used by a contractor is the "new value rule." This exception protects a payment from preference attack when the contractor receiving the payment subsequently advances new value to the project owner. For example, if the supplier received payments of $150,000 within 90 days before the debtor's bankruptcy filing yet shipped $200,000 worth of materials during that same time period, it would not be a preference. The rationale behind this exception is that because of the extension of new value to the debtor, the bankruptcy estate is not diminished by the prior preferential payment. The otherwise preferential payment is only protected to the extent of the value subsequently supplied by the contractor. Though not often viewed from this perspective, the continued work of a contractor should constitute new value advanced to the debtor. To the extent that construction work continues after the payment is made, there should be a new value defense to the preference action seeking to reclaim a project payment.

H. Trust Fund Defense

A trust fund defense may also be applicable. The trust fund defense to a preference action is not technically an exception to the Bankruptcy Code preference rules, like the substantially contemporaneous exchange of value, ordinary course of business, or subsequent new value defenses previously discussed. Instead, the trust fund defense seeks to demonstrate that the funds paid to the contractor were not the property of the owner/general contractor or its bankruptcy estate because the funds are held in trust for the benefit of the contractor.

Under the law of many states, construction contract proceeds are impressed with a "trust" in favor of unpaid contractors and suppliers. Regrettably, Arizona does not have such a trust fund statute as to commercial construction projects (but does as to owner-occupied residential projects—A.R.S. § 33-1005). However, the case law provides some support for use of a provision in the construction contract to establish the requisite "trust fund." Very specific language must be used to create an enforceable trust. Including trust fund language in the prime contract may offer significant protections to a contractor from a bankruptcy standpoint. The owner's loan documents should also be reviewed for language that may impress a trust upon construction funds for specified use. However, it does not appear to be a common practice in Arizona to contractually impress a trust upon funds in connection with construction projects. Indeed, the standard forms of contract (AIA and Consensus Docs) do not include terms that obligate the general contractor to hold contract proceeds in trust for the benefit of the subcontractors and suppliers whose work and materials are supplied to the project.

I. Earmarking or Joint Check Defense

Like the trust fund defense, this doctrine defends a preference claim by demonstrating that the funds paid to a contractor were not really the "property" of the general contractor who paid them. If the funds were paid to the general contractor by the owner specifically to be paid to a subcontractor, particularly if they were paid by joint check, bankruptcy courts have held that payments were not a recoverable preference. The theory is that the bankruptcy estate was not diminished, because the general contractor would not have received the funds, but for compliance with the restriction.

General contractors face a difficult burden in proving exceptions to preference claims. The contractor's normal reaction of outrage when compelled to return payments to a bankrupt owner is understandable. The seriousness of the preference action cannot be avoided by simply clinging to notions of "fair play" or "common sense." Preference actions are all too frequently lost by contractors trying to hold on to the money received from a bankrupt owner/general contractor.

Prompt steps should be taken to obtain and preserve all possible information concerning the status of the project and its financial condition when dealing with a "troubled" owner or general contractor. The amount and nature of contract proceeds, construction loans on the property, etc., are all facts necessary to establish the preference defenses. A full history of the owner and the contractor's prior business dealings will be needed to analyze of the applicability of an ordinary course exception. Contractors must be aware of the bankruptcy preference rules when assessing the credit worthiness of a project owner/general contractor or when deciding to continue work in the face of slow-pay or no-pay history.

V. PROOF OF CLAIM

11 U.S.C. § 501 allows a creditor to file a Proof of Claim in a debtor's bankruptcy case for amounts owed the creditor on the date the debtor filed bankruptcy. Even if a creditor does not intend to pursue the bankrupt contractor, a Proof of Claim should still be filed. If amounts are owed for open account indebtedness and/or materials supplied or labor performed, without some "security," the creditor will be classified and treated as a general unsecured creditor and one of the last classes of creditors of the bankrupt contractor to be paid.

If a creditor has presented a reclamation claim, a creditor selling goods on open account will be classified and treated as an administrative claim for any goods sold within 20 days prior to the debtor's bankruptcy filing. This administrative claim status entitles the creditor to priority of payment ahead of unsecured creditors and certain other classes of claimants.

Finally, if there is some security (*i.e.*, a recorded Mechanic's Lien) a creditor would file a proof of claim as a secured creditor since there is real property arguably supporting the value of the materials supplied and/or labor performed by the creditor.

The mere filing of a Proof of Claim ensures that, to the extent payments are made to creditors at some future point in time, the creditor will at least receive some compensation from the bankrupt contractor or owner.

VI. NON-DISCHARGEABILITY LITIGATION

In certain limited circumstances, certain indebtedness owed by the debtor/contractor may not be subject to discharge in bankruptcy. If all or any portion of the indebtedness owed a creditor by the debtor can be classified as non-dischargeable, the creditor is in essence, assured of payment through continued collection efforts. Furthermore, if the debtor fails to pay, even post-bankruptcy, the creditor can continue to pursue the debtor for all amounts declared non-dischargeable by the Bankruptcy Court. Although there are other bases to have debt declared non-dischargeable, the traditional basis for non-dischargeability claims against a bankrupt contractor are (1) false representations regarding an extension, renewal, or refinancing of credit, 11 U.S.C. § 523(a)(2); (2) fraud or defalcation while acting in a fiduciary capacity, §523(a)(4); and (3) willful and malicious injury by the debtor to another entity or property of another entity, §523(a)(6). These grounds for having a debt declared non-dischargeable are discussed below.

A. Non-Dischargeability Pursuant to 11 U.S.C. § 523(a)(2) Financial Information

Upon the contractor's filing for bankruptcy, a creditor should review its credit file to see if the credit application contains a financial statement (or if one was provided at the time the credit was granted) and carefully compare the assets listed in the credit application to the assets and liabilities listed by the contractor on its bankruptcy schedules. Frequently, when examined about these assets at the initial 341 meeting of creditors, debtors will testify that certain listed assets were either not owned by the debtor, overstated in value, or disposed of long before the credit was requested and obtained. Such statements will be extremely helpful in prosecuting a non-dischargeability claim alleging that the debtor misrepresented its financial condition and as a result, credit was extended. Assuming a creditor can prove fraud or misrepresentation as part of the extension of credit, the debt owed the creditor would not be subject to discharge.

B. Non-Dischargeability Pursuant to 11 U.S.C. § 523(a)(4) Defalcation While Acting in a Fiduciary Manner

A.R.S. § 33-1005 imposes a trust relationship between the contractor, its subcontractors and suppliers. The statute provides that in residential construction, when the contractor receives funds from an "owner occupant," the contractor holds the funds in "trust" for the benefit of subs and suppliers to the residential project. If the contractor fails to pass along these funds to subs and suppliers, it may constitute a defalcation while acting in a fiduciary capacity for purposes of 11 U.S.C. § 523(a)(4).

This theory has been adopted in Arizona pursuant to *In re Baird*, 114 B.R. 198 (B.A.P. 9th Cir. 1990). In *In re Baird*, the debtor argued that the statute was never intended to create the type of trust obligation that would not be dischargeable in bankruptcy. The debtor pointed out that A.R.S. § 33-1005 does not obligate the contractor to segregate the trust funds or otherwise maintain the separate identity of the funds received from the owner occupant. The Court disagreed and found persuasive decisions of other courts in other states with similar statutes. As importantly, because subcontractors' lien rights were severally abrogated, the strict enforcement of trust principles was necessary to ensure subcontractors were protected. The decision is even more significant in that the appellate court was willing to disregard the corporate veil, though corporate proprieties were followed. The Court cited a number of decisions prohibiting an individual from utilizing the corporate veil to shield himself from fraudulent activity. Since Baird was an individual who made the decision to misdirect the funds, he was liable directly to subcontractors under state law.

The validity of the *In re Baird* decision was reaffirmed by the Ninth Circuit Appellate Panel in the case of *T & D Moravits & Co. v. Munton (In re Munton)*, 352 B.R. 707 (B.A.P. 9th Cir. 2006). In the *Munton* case, a construction company was provided with concrete by a subcontractor for use in the construction of townhouses. The subcontractor did not get paid and sued the contractor and its principals, including Mr. Munton, asserting that they had violated the Texas Construction Trust Fund Statute (the "Texas Trust Statute"). The Texas Trust Statute provides that under a construction contract for the improvement of specific real property in Texas, a person will be liable if they intentionally or knowingly divert the contract payments without first paying all current and past due obligations owed to the beneficiaries of the trust. In an effort to avoid the implication of the statute, Munton filed a Chapter 7 petition. The subcontractor filed a complaint for non-dishargeability pursuant to 11 U.S.C. § 523(a)(4). The court found that while the Texas Trust Statute's language clearly defines "the trust res. . . . imposes fiduciary duties. . . . and imposes the trust," sufficient to "create the requisite fiduciary relationship for purposes of § 523(a)(4) analysis." *Id*. at 715. The *Munton* court went on to conclude that Mr. Munton had committed defalcation, a failure of a party to account for money or property that has been entrusted to them, while in the fiduciary capacity, and was liable for the amounts that should have been paid to the subcontractor.

The impact of non-dischargeability under § 523(a)(4) has been limited by the United States Supreme Court, which added a culpable state of mind requirement "involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior." *Bullock v. Bank Champaign, N.A.*, 133 S.Ct. 1754, 1756 (2013).

C. <u>Non-Dischargeability Pursuant to 11 U.S.C. § 523(a)(6) Willful and Malicious Injury</u>

If a debtor willfully or maliciously injures another or their property, a debtor can lose its right to discharge the debt. This type of scenario frequently occurs where a debtor destroys a house, which is collateral for a loan before moving out after foreclosure. Similarly, if a contractor destroys or allows to be destroyed property of another, the resulting damage may be able to be declared non-dischargeable.

VII. <u>NEW SMALL BUSINESS REORGANIZATIONS</u>

The SBRA of 2019 took effect February 19, 2020. It created a streamlined and expedited way for small businesses to reorganize without the time and requirements of Chapter 11.

A "Small Business" debtor can be an individual or an entity, engaged in commercial or business activities whose total secured and unsecured debts are not more than $3,024,725, not less than 50% of which arose from commercial or business activities. Notably, as part of the CARES act, this debt limit was temporarily raised to $7,500,000, dramatically increasing the number of debtors eligible for Subchapter V relief. When the debt limit was originally raised, it was designed to sunset in March 2021, but due to its widely acknowledged success and popularity it was extended through March 2022. The increase was expected to be further extended, however, despite bipartisan support, delay in Congress prevented a further extension and the increased debt ceiling sunset on March 28, 2022. However, as of April 12, 2022, the pertinent Bill, which would set a $7,500,000 threshold for another two years, has passed the Senate unanimously and is awaiting consideration in the House. Accordingly, the debt limit for SBRA eligibility is something interested parties should continue to monitor in the coming weeks.

"Estate" (§ 101 (51D)(A)) includes all property acquired by the debtor pre- and post-bankruptcy filing until the case is closed, dismissed or converted, including earnings for service performed post-bankruptcy filing (§ 1186).

Small Business Debtors must attach to their bankruptcy petition its most recent balance sheet, statement of operations, cash-flow statement, and federal income tax return or declare under penalty of perjury no such documents have been prepared (§ 1187).

A mandatory status conference is held not less than 60 days after bankruptcy filing to discuss the expenditures and economical resolution of the case. Fourteen days before the status conference a report must be submitted detailing debtor's efforts undertaken to achieve a consensual plan (§ 1188).

A standing trustee is appointed (§ 1183) and makes payments to creditors under the plan until substantial consummation (§ 1194).

There is no disclosure statement required (addressed in plan) (§ 1187(c)).

Debtor may file plan of reorganization (§ 1189 and § 1190) within 90 days which addresses:

- Brief history of business operations;
- Liquidation analysis;
- Projections regarding debtor's ability to reorganize;
- Future earnings are paid to the trustee to facilitate execution of the plan (§ 1190).

The plan can be confirmed over creditor objection provided the plan does not discriminate unfairly and is fair and equitable as to other impaired classes of creditors (§ 1191(b)).

Absolute Priority Rule does not apply (§ 1181(a)).

A plan is considered "fair and equitable" as to secured creditors, if it satisfies one of the following factors:

1) Secured creditor retains its lien and receives cash payments equal to their allowed claim amounts;

2) Secured creditor's collateral is sold, claimant's lien attaches to the sale proceeds; or

3) If neither 1 nor 2, secured creditor must receive the indubitable equivalent of their claim (§ 1191(c)).

VIII. CONCLUSION

Although construction is booming in Arizona, the construction industry needs to be reminded of how to collect from and retain amounts received from a bankrupt contractor. Upon rumors of a bankruptcy filing by your contractor, you should immediately contact an attorney with both bankruptcy and construction law experience, to enhance the likelihood that you will receive and/or be able to retain payment(s) from your bankrupt contractor.[3]

[3] The information contained in these materials is not intended to be legal advice on how to proceed in these instances. Should any of the situations set forth above arise, you should contact your attorney for specific advice.

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For more than 40 years, Randy Nussbaum has assisted individuals and businesses with complex bankruptcy protection (debtor and creditor), transaction and litigation matters. He especially enjoys helping his clients achieve their business and financial objectives using innovative legal strategies. Randy has represented secured and unsecured creditors, surety companies, creditor committees, lessors, professional athletes, doctors, lawyers, and trustees in Chapter 7, 11, and 13 proceedings, including adversary actions (bankruptcy litigation). The cases have involved such diverse matters as real estate, construction, manufacturing, trucking, asset-based lending, bankruptcy related to divorce, and high-value, and complex individual bankruptcies.

Randy is a Certified Bankruptcy Specialist (Arizona Board of Legal Specialization) and a Certified Business Bankruptcy Specialist (American Board of Certification). Randy is a respected lecturer and author on topics regarding bankruptcy, construction, and real estate. His peers have honored him with multiple peer rankings for his professional achievements. Randy has been named to the Super Lawyers' "Top 50" list of Arizona attorneys multiple times and has been selected as one of The Best Lawyers in America© since 2010. *Best Lawyers* also has twice selected Randy as its "Lawyer of the Year" (Scottsdale), in Bankruptcy and Creditor Debtor Rights (2019) and in Bankruptcy Litigation (2021).

Recognized for his life-long commitment to community service, in 2018 Randy joined the distinguished roster of honorees inducted into the Scottsdale History Hall of Fame.