AMERICAN BANKRUPTCY INSTITUTE

2023 Annual Spring Meeting

The Intersection of Bankruptcy and Construction Law

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CONCURRENT SESSION

2023

American Bankruptcy Institute
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PART ONE: CONSTRUCTION ISSUES TO CONSIDER AT THE BEGINNING OF A CASE

I. ADEQUATE PROTECTION ISSUES

A. *In re Vander Vegt*, 499 B.R. 631 (Bankr. N.D. Iowa 2013) - *Vander* addresses issues of adequate protection when a Debtor seeks to incur additional debt post-petition.

1. Facts: In *Vander*, the Debtors owned a dairy farm in Jefferson County, NY. The Debtors later purchased a farm for $1.35 mm in Butler County, IA and relocated. First Security Bank & Trust Company ("FSBTC") financed their purchase and received a blanket lien on all of Debtor's property, including their NY operations.

a. Over the next few years, Debtor's cattle numbers dropped significantly, and the milk production suffered. The Debtors filed for Chapter 12 and subsequently sought permission to obtain financing, arguing that they needed to increase milk production to become solvent. They said the farm could only accommodate more cattle if they replaced the existing waste storage system, which is near capacity. Without a new system the Iowa Department of Natural Resources could close down the operations.

b. The Debtors also sought authority to incur additional secured debt to construct a rotational grazing facility for the farm, arguing that such a system reduces overhead while generating healthier cattle with increased milk production. The Debtors proposed to receive this additional financing from First National Bank ("FNB") and sought to grant FNB a priming lien on their property. The Debtors also testified that they are close to receiving $300,000 from the U.S. Department of Agriculture in the form of two grants, which would provide security for FNB. The debtors said that once construction was complete on the two projects, they would use the grant money to pay off the FNB loan entirely

c. FSBTC claimed that its interest would not be adequately protected because subordination of its position denied the key benefit of its bargain – the position as priority lien holder on Debtor's property.

2. Holding: The court disagreed with FSBTC, holding that the likely increased value of the farm, the short duration of the new financing and the near certain grant payments gave FSBTC the indubitable equivalent, pursuant to 11 U.S.C. § 361, that qualified as adequate protection. The court further noted that the risk to FSBTC, receiving $300,000 less than they would have without the priming lien, was very low. The court granted the Debtors' request to incur additional secured debt, conditioned on their taking any remaining actions required to qualify for the USDA grants.

B. *In re Westport Holdings Tampa, Ltd. P'ship, 607 B.R. 715 (M.D. Fla. 2019) -* Westport Holdings addresses questions of adequate protection in the context of replacement post-petition financing to construct improvements.

1. Facts: The Debtors owned and operate a retirement community in Tampa, FL. CPIF Lending, LLC ("CPIF") held a secured claim of roughly $9.7mm secured by all of Debtors' assets. The Debtors required roughly $2mm in post-petition financing to make improvements to the roof and to fund operational expenses until a sale could be completed. SouthPoint Global Investments, LLC ("SouthPoint") agreed to extend the Debtors this financing.

a. The court entered an order authorizing the Debtors to borrow up to $2mm from SouthPoint. SouthPoint received a (1) first priority lien on any unencumbered assets of the Debtors; (2) a second priority lien on all encumbered assets of the Debtor, junior only to CPIF; and (3) a junior-priority lien on all encumbered assets of Westport Nursing Tampa, LLC, an affiliated entity.

b. The liquidating trustee entered into a roofing contract, and after a few advances to pay invoices, SouthPoint refused to continue funding the payment of these invoices. In light of SouthPoint's refusal, the liquidating trustee agreed with CPIF for replacement financing.

c. At a hearing to approve the replacement financing from CPIF, SouthPoint's counsel argued that under the terms of the loan documents in the event of a default, which included attempting to grant a lien in any of the Debtors' assets, SouthPoint must be paid in full before any replacement financing could be obtained. Over the objection of SouthPoint, the bankruptcy court approved the replacement financing from CPIF and granted CPIF a first priority lien in the Debtors' assets.

2. Holding/Analysis: The U.S. District Court, on appeal, affirmed the decision of the bankruptcy court. The District Court held that SouthPoint was adequately protected pursuant to 11 U.S.C. § 364(d), such that a priming lien in favor of CPIF was appropriate, because there was a $3.2mm equity cushion in the property, which well exceeded the $488,000 that SouthPoint had advanced before refusing to make any additional advances.

a. The court also noted that SouthPoint's interest had been increased by the value of the CPIF replacement loan.

b. The court further stated this case is a prime example of why bankruptcy courts should be allowed to grant post-petition financing that replaces and supplants earlier post-petition financing because SouthPoint was refusing to advance funds and the liquidating trustee made clear that the Debtors desperately needed funds to complete repairs and operate during the pendency of the bankruptcy.

C. *In re Packard Square LLC*, 574 B.R. 107 (Bankr. E.D. Mich. 2017) – This case involved several issues, including a receivership and adequate protection, DIP financing.

1. Facts: Packard Square LLC (the "Debtor") obtained a $53.7 million loan from CAN IV Packard Square LLC ("Canyon") to finance construction of a mixed-use development. When the debtor defaulted on certain obligations under the loan documents, Canyon obtained a state court order appointing a receiver. Construction of the project was only half completed.

a. The state court granted the receiver authority to obtain a receivership loan in order to complete the project. The receiver obtained the loan, hired a general contractor, and construction continued for ten months. Two days before the state court was to hear a motion by the receiver seeking authority to increase the amount of the receivership loan, Packard filed for Chapter 11 relief.

b. The debtor filed a first day emergency motion seeking an order requiring the receiver to turn over all of the debtor's property and to file an accounting. Canyon filed a cross-motion seeking an order excusing the receiver from complying with the Code's turnover and accounting provisions. Canyon also sought an order "suspending" the bankruptcy case under Sections 305(a)(1) and 105(a).

2. Holding/Analysis:

a. The bankruptcy court denied the debtor's turnover motion and granted Canyon's motion. The interests of creditors and equity security holders would be better served by excusing the receiver, pursuant to Section 543(d)(1), from complying with the turnover and accounting obligations under Sections 543(b)(1) and Section 543(b)(2), and by dismissing the Chapter 11 case under Section 305(a)(1).

b. The most important factor was that the court also denied the Debtor's DIP financing motion.

(i) With respect to the DIP financing issue, the Debtor sought, pursuant to 11 U.S.C. § 364, to borrow $22,006,132 from Ardent Financial Fund II, L.P. ("Ardent"), and of that amount, it sought an interim order immediately allowing it to borrow $1.5mm. The purpose of the loan was to complete the project. To secure the loan, the Debtor sought to grant Ardent a priming lien and a super-priority administrative expense claim. The Debtor contended that adequate protection existed based on an equity cushion.

(ii) After discussing in length the debts currently secured by the property and the value of the property, the court disagreed and found that Debtor failed to meet its burden of proving adequate protection in the form of an equity cushion. In so holding, the court took issue with the fact that all appraisals obtained by the Debtor reflected the value once the project was complete. However, even accepting these values, the court found several flaws with their projections and concluded that no equity cushion existed.

D. *In re Hari Ram, Inc.*, 507 B.R. 114 (Bankr. M.D. Pa. 2014) - *Hari Ram* addresses what constitutes adequate protection for use of hotel revenues constituting cash collateral.

1. Facts: The Debtor was the owner and operator of a hotel in Mechanicsburg, PA. Debtor's primary lender, Magnolia Portfolio, LLC ("Magnolia"), retained a first mortgage on the hotel and an assignment of rents. The Debtor also granted two junior mortgages in the hotel to secure loans made to related entities.

a. On December 13, 2013, Magnolia sent a letter to Debtor stating that Debtor was in default and it had elected to collect "proceeds" generated by the hotel.

b. In response to this demand for payment of hotel revenues, Debtor filed a Chapter 11 petition. The Court entered an interim cash collateral order authorizing Debtor's use of cash collateral, subject to certain limitations. A final hearing was held on February 4, 2014.

2. Holding/Analysis:

a. At the outset, the court was asked to determine whether hotel revenues are interests in real property. If so, the protections afforded to mortgagees under Pennsylvania law must be considered. The court declined to take up this issue, finding that Magnolia did not take any steps to terminate the Debtor's interest in the hotel revenues, but indicated it believed that hotel revenues are not rents.

b. Next, the court was asked whether the Debtor retained an interest in hotel revenues after the petition was filed, such that Magnolia could obtain the right to receive the revenues. The court found that because hotel guests are not tenants, the revenues remained property of the bankruptcy estate.

c. Finally, although Magnolia was unable to cutoff the Debtor's interest in the hotel room revenue, it was still entitled to adequate protection. The court found that adequate protection had not been supplied because (i) the offer of a replacement lien in post-petition rents was hollow in that Magnolia already had a lien on this property; (ii) the additional mortgages on the property consumed any equity cushion; and (iii) in the absence of other sources of adequate protection a positive cash flow forecast is inadequate.

II. PRIMING AND PRIORITY ISSUES

A. *In re Moultonborough Hotel Grp., LLC*, 726 F.3d 1 (1st Cir. 2013) - Addresses the priority between a mortgage and a contractor's mechanic's lien on a newly-constructed hotel.

1. Facts: ROK Builders LLC ("ROK") signed a contract in 2006 to build a hotel for Moultonborough Hotel Group ("Moultonborough"). ROK began work but terminated the contract in April 2007 due to nonpayment of $1.6 million. Moultonborough then obtained a commitment from Specialty Finance Group ("Specialty") to extend new funding to restart the project. ROK signed a new construction agreement with Moultonborough in September of 2007.

a. Specialty recorded the construction mortgage granted by Moultonborough in October of 2007. Specialty paid ROK $1.8 million to settle the amount due under ROK's original construction contract. ROK continued construction, receiving loan disbursements from SFG. In conjunction with the disbursements, ROK executed two lien waivers acknowledging payments from SFG. When it submitted its final waiver, ROK was unaware that Specialty had decided to stop payments due to Moultonborough's failure to secure additional financing that the loan agreement required.

b. Specialty did not inform ROK of its decision even when it received the waiver, and ROK performed further work, still unaware that it would not be paid. When the hotel opened in 2008, ROK was owed $2.48 million. Specialty's parent company failed in 2009. Specialty assigned the mortgage to the FDIC, which assigned it to SFG Venture LLC ("SFG").

c. Moultonborough filed for Chapter 11 relief in 2009. SFG commenced an adversary proceeding seeking a declaration that $6.4 million of the mortgage, the amount SFG disbursed to ROK for work performed under the 2007 construction contract, was senior to ROK's mechanic's lien. ROK counterclaimed seeking a determination that its lien was senior to SFG's mortgage and advancing secondary counterclaims for breach of implied contract, promissory estoppel, and unjust enrichment.

d. The bankruptcy court granted SFG's motion to dismiss the secondary counterclaims and granted SFG's motion for summary judgment on the seniority claims. The district court affirmed.

2. Holding/Analysis: The First Circuit affirmed. In so holding, the First Circuit rejected ROK's argument that because it began work on the hotel before SFG's mortgage was recorded, any lien arising out of work performed at any time took priority over the mortgage, even to the extent the mortgagee paid for such work.

a. The First Circuit noted that New Hampshire's race notice rules favored SFG because the mortgage was recorded well before the work for which ROK claimed a lien was performed.

b. The First Circuit further noted that the statute providing an exception to the race notice rule for mechanic's liens did not apply because it was subject to the qualification that a mechanic's lien would not be entitled to precedence where the mortgagee shows that the loan proceeds were disbursed toward payment of invoices for materials or labor.

c. Because payment was in fact previously made to ROK by Specialty, the lien for that paid work expired and ROK was left only with a lien for later work.

B. ***In re 450 S. W. Ave., LLC*, 633 B.R. 894 (B.A.P. 9th Cir. 2021) - *450 S.W.* involves the determination of the validity, priority, or extent of a mechanic's lien claimant.**

1. Facts: In 2017, 450 S. Western Ave., LLC ("Debtor") contracted with Philmont Management Inc. ("Philmont") to perform tenant improvements at a three-story shopping center located in Los Angeles, CA.

a. When not timely paid, Philmont recorded a mechanic's lien on July 18, 2018. Over the next eighteen months, the Debtor repeatedly assured Philmont that it would be paid and requested that Philmont not file a lawsuit because it was working on a refinance and a lawsuit would cloud title. Accordingly, Philmont did not file a cause of action, but instead re-recorded its mechanic's lien four additional times with its final recording occurring on December 19, 2019.

b. The Debtor filed a chapter 11 petition on January 10, 2020 and Philmont filed a Notice of Perfection of Mechanic's lien on April 29, 2020 and a proof of claim on May 28, 2020. The Debtor auctioned off the shopping center and when it filed its plan of liquidation and disclosure statement, it disputed the extent, validity, or priority of Philmont's mechanic's lien.

c. Philmont commenced an adversary proceeding to determine the validity, extent or priority of its mechanic's lien, but the bankruptcy court granted a motion to dismiss filed by the Debtor. Philmont appealed that decision and the Ninth Circuit BAP confirmed the bankruptcy court's decision.

2. Holding/Analysis:

a. Under California law a mechanic's lien must be filed within ninety days after completion of the work or sixty days after the owner records notice of completion, whichever is earlier. To preserve the enforceability of a timely recorded mechanic's lien, the contractor must commence an action to foreclose within 90 days of recordation. If the claimant does not commence an action to enforce the lien within that time, the claim of lien expires and is unenforceable. The allegations of Philmont's complaint established that it failed to file a foreclosure action within the time fixed to preserve the validity and enforceability of its mechanic's lien.

b. The BAP declined to address Philmont's claim of equitable estoppel based on the Debtor's repeated misrepresentations and concluded that even if the December 2019 recording were timely Philmont failed to give timely notice under 11 U.S.C. § 546(b). In sum, this statute states that if commencement of an action is required to perfect, or to maintain or continue perfection of an interest in property, and that action has not been commenced pre-petition, the claimant may perfect or maintain or continue perfection, i.e., preserve the enforceability of its perfected lien, by giving notice within the time fixed by such law for such seizure or such commencement. Even if the December 2019 recording were deemed timely, Philmont had 90 days from that date to provide notice in the bankruptcy. It did not do so.

c. The BAP rejected Philmont's argument that Section 108(c), tolled the time for filing a 546(b) notice. Section 108(c) tolls the expiration of a statute of limitations when the automatic stay prevents the filing of a suit before the deadline. Because 546(b) provides an alternative, the giving of notice, to perfect or maintain perfection, Section 108(c) is inapplicable.

C. *In re Corbin Park, L.P.*, 470 B.R. 573 (B.A.P. 10th Cir. 2012) - This case features a lien priority dispute between a mechanic's lien claimant and the construction lender.

1. Facts: Metcalf LLC ("Metcalf"), the prior owner of the property, hired Brown Commercial Construction ("Brown") as general contractor to prepare the site for construction. Subcontractors were hired and work began in 2007.

a. The following year, Metcalf advised Brown that it was no longer able to fund the construction. Metcalf made presentations to potential investors in which Brown participated. In April 2008, Metcalf stopped paying Brown. In August 2008, anticipating the sale of the property, Metcalf informed Brown that it would be closing its contract with Brown, and that Brown would be required to enter into a new contract with the purchaser.

b. A new investor, Invesco Ltd. ("Invesco"), formed Corbin Park, L.P. ("Debtor") to purchase the property. Brown entered into a new written agreement with the Debtor in September of 2008. Under such agreement, the construction commencement date was dependent upon written notice to proceed from the Debtor. Also, because of Brown's bonding capacity limitations, the debtor entered into a contract with a second general contractor, Taylor Kelley.

c. The sale closed on October 8, 2008. On the same day, the Debtor and Bank of America executed a construction loan agreement. The next day, the Debtor sent written notice to proceed with construction under the Brown and Taylor Kelly contracts. Bank of America recorded its mortgage on October 10, 2008. Funds from the Bank of America loan and Invesco's capital investment were used to pay off most of Metcalf's costs, which included the invoices submitted by Brown and its subcontractors for work performed up to August 24, 2008. None of the contractors filed a mechanic's lien against the property with respect to work performed under contracts with Metcalf. A year later, on August 6, 2009, Brown issued a stop work notice to its subcontractors because the Debtor failed to make payments. Brown and its subcontractors then filed mechanic's liens.

d. The Debtor filed for Chapter 11 relief. The bankruptcy court ruled that Bank of America's interest in the property had priority over the mechanic's lien interests of the contractors and subcontractors. The contractors and subcontractors did not furnish lienable labor and materials under a contract with the debtor prior to the recordation of BOA's mortgage.

2. Holding/Analysis: The 10th Circuit BAP affirmed.

a. Brown argued that the mechanic's liens related back to August 24, 2008, the first day of work billed under its contracts with the debtor, and constituted first priority liens on the property. However, the BAP rejected the arguments raised by Brown and the other contractors on appeal.

b. The BAP held, inter alia, that the bankruptcy court's finding that Brown did not perform lienable work on the debtor's property with its own forces prior to Bank of America's mortgage was not clearly erroneous. The bankruptcy court did not conclude, as Brown argued, that Brown performed work during the critical time period but that such work was not consequential enough to create a lien. Rather, the bankruptcy court concluded that the contractors did not prove that they performed work on the debtor's property prior to the filing of Bank of America's mortgage, and further, that if they did, such work was not performed "under a contract with the owner," as required by Kansas mechanic's lien statute.

D. *In re Kappa Dev. & Gen. Contracting Inc.*, No. 17-51155-KMS, 2019 WL 2867110 (Bankr. S.D. Miss. July 2, 2019) - This case involves a priority dispute between a bank and surety in the construction context.

1. Facts: Kappa Development and General Contracting Inc. ("Debtor") filed for Chapter 11 after having lost money on two government projects. Prior to bankruptcy, the Debtor entered into a lending arrangement with The First ("First") and granted a lien on all assets.

a. After the First perfected its lien, Hanover Insurance Company ("Hanover") issued payment and performance bonds on the Debtor's behalf. The Debtor was unable to pay several subcontractors and a provider of workers' compensation insurance. Hanover paid these parties about $200,000 to cover what they were owed.

b. Meanwhile, the Debtor was in default to the First for about $800,000. Before and after bankruptcy, as part of various settlement agreements, the Debtor received final payments from the owners of the two projects. The final payments included about $190,000 (the "Retainage"). The First and Hanover both claimed a right to the Retainage. The First argued that its lien came ahead of

Hanover's rights. Hanover contended that its right of equitable subrogation was superior to the bank's lien. Both sides filed motions for summary judgment and the bankruptcy court agreed with Hanover, finding it was entitled to the Retainage because its right of subrogation was superior to the First's perfected security interest.

2. Holding/Analysis: The court noted that equitable subrogation applies whenever someone other than a volunteer pays a debt that should have been paid by someone else.

a. Additionally, the court emphasized that equitable subrogation is not governed by the rules of priority in the UCC, it is based in equity. Critical to the court's ruling was that the Mississippi Supreme Court had previously ruled that a surety's right of equitable subrogation is superior to the rights of a secured lender.

b. With all this in mind, and combining the principles of state and federal law, the court ruled that the retainage received before bankruptcy never became property of the estate and that the retainage received after bankruptcy became property of the estate subject to the surety's right of equitable subrogation.

III. Trust Fund Considerations

Trust funds in the construction context are common tools to protect lower-tiered subcontractors and suppliers by imposing a trust over funds remitted from a lender, project owner, or higher-tiered contractor to the lower-tiered party for the purpose of paying the downstream claimants.

A. When do construction trusts arise?

1. Statutory Trusts

a. Several states have construction trust fund statutes. Under the construction trust fund statutes, the trust arises automatically without any special action by the parties.[1]

b. The scope (*e.g.*, public versus private projects, potential beneficiaries, etc.) and potential remedies and penalties for violating the statute will vary from state to state.

(i) For example, in some states, violations can lead to personal liability and criminal liability. *See, e.g.,* Mich. Comp. Law §§ 570.151-570.153; *see also* Colo. Rev. Stat. §§ 18-4-401, 38-22-127; N.Y. Lien Law Article 3-A.

(ii) Other states may not have an express construction trust fund statue, but nonetheless may still impose criminal liability on the contractor

[1] *See, e.g.*, Md. Code Ann. Real Prop. § 9-201(b); Tex. Prop. Code § 162; Ariz. Rev. Stat. § 33-1005.

who is paid by an owner and fails to pay a subcontractor. *See, e.g.,* Ga. Code § 16-8-15; *see also Wachovia Bank v. Am. Bldg. Consultants*, 138 B.R. 1015 (Bankr. N.D. Ga. 1992); *see also* Fla. Stat. § 713.345; Ark. Code Ann. § 18-44-132.

(iii) Some states impose additional monetary penalties, *e.g.*, treble damages for violating the trust fund statute, interest, and attorneys' fees. *See, e.g.*, Colo. Rev. Stat. § 18-4-405; Del. Code Ann. Tit. 6 §§ 3502-3509

(iv) Many states do not require the trust funds to be segregated to impose a trust over the funds. *See, e.g.,* Ariz. Rev. Stat. § 33-1005; Del. Code Ann. Tit. 6 §§ 3502-3509.

2. Express Trusts

a. Construction contract – Many construction contracts will include language that requires the contractor or subcontractor to hold monies received for the payment for lower-tiered parties in trust.

b. Surety's indemnity agreement – A surety's indemnity agreement sometimes also provides that any contract proceeds received by the indemnitor are held in trust for the benefit of the potential bond claimants.

c. Whether an express trust is formed in either context will ultimately depend on state law. *See, e.g., In re LandAmerica Fin. Grp., Inc.*, 412 B.R. 800, 811 (Bankr. E.D.Va. 2009).

3. Constructive Trusts. Some courts have looked at equitable principals or mechanic's lien law to find that a constructive trust exists.

a. For example, "Georgia law recognizes the constructive trust fund doctrine with respect to payments owed materialmen by their contractors for improvements made to a third party's realty." *Bethlehem Steel Corp. v. Tidwell,* 66 B.R. 932, 939-40 (M.D. Ga. 1986). The constructive trust fund is narrow, however, and only extends to payments that do not exceed amounts owing to materialmen and require that payments are made to the general contractors at time when materialmen have either a valid lien on the owner's property or a right to file lien. *Id.*

b. The District of Columbia also imposes a constructive trust when limited situations. *See Heck v. Adamson*, 941 A.2d 1028, 1029 (D.C. 2008) ("where a person who holds title to property is subject to an equitable duty to convey it to another on the ground that he would be unjustly enriched if permitted to retain it") (quoting *Gray v. Gray,* 412 A.2d 1208, 1210 (D.C. 1980)).

B. Construction Trust Funds in Bankruptcy.

1. Use of cash "collateral" under 11 U.S.C. §§ 363, 364. Trust funds are not property of the debtor's estate. 11 U.S.C. § 541(d); *see also In re Dameron,* 155 F.3d 718, 721-22 (4th Cir. 1998).

2. Non-dischargeability. Some states impose personal liability on the corporate officers and directors for misappropriation of construction trust funds. Consequently, these debts may not be dischargeable in bankruptcy. *Woodworking Enter., Inc. v. Bairs*, 114 B.R. 198 (9th Cir. 1990).

IV. MECHANIC'S LIENS

A. What are Mechanic's and Materialmen's Liens?

A mechanic's lien is a statutory lien created by state law which provides a means of securing payment for contractors, subcontractors, lower-tier subcontractors, suppliers and materialmen, laborers, architects and engineers working on projects for the construction, improvement, or repair of a building or other property.

B. When Mechanic's and Materialmen's Liens Arise; Perfection; and Priority.

1. When Mechanic's Liens Arise. The specific state where the construction is being performed will dictate when a mechanic's lien initially arises.

a. In many states, the mechanic's lien is an inchoate lien that automatically arises when work first commences on the project or materials or delivered to the project, such that when the claimant takes steps to perfect their lien, it "relates back" to such date.[2]

In California, a mechanic's lien is entitled to "off-record priority", such that the priority of the mechanic's lien relates back to the commencement of work and not the date of recordation of the lien. *See* Cal. Const. Art. XIV, § 3; Cal. Civ. Code § 8450(a); *Sax v. Clark*, 180 Cal. 287, 288-91, 180 P. 821 (1919); *Greenblatt v. Utley*, 240 F.2d 243, 246 (9th Cir. 1956) ("[t]he lien dates from the time of the commencement of the work"); Miller & Starr, *California Real Estate* 4th ed., §§ 32:6, 10:130 (2021).

Virginia also has an inchoate lien that arises automatically upon when the work commences at the project. *See* Va. Code Ann., § 43-21.

[2] In some states, the inchoate lien arises in favor of all potential lien claimants when work on the project first commences, regardless of when the individual claimant first performs work or supplies materials. *See, e.g.,* Miller & Starr, *California Real Estate* 4th ed., §§ 32:6, 10:130 (2021) (in California, "[t]he priority of a mechanic's lien relates back to the date work commenced for all claimants, no matter when the claimant's work actually began").

b. In other states, however, the inchoate lien does not automatically arise when the claimant first supplies labor or materials to the job, but rather, the claimant must take affirmative action to establish the lien.

> In Maryland, a potential claimant has to file a petition to establish a lien. *See* Md. Code Ann., §§ 9-101, 9-104, 9-105. There is no statutory provision that allows the lien to relate back to when work was commenced. *See id.*
>
> New Jersey's mechanic's lien statute does not relate back but is established as of the date of filing. *In re Linear Electric Co.*, 852 F.3d 313, 323 (3d Cir. 2017).

2. Perfecting Mechanic's Liens. The rules for perfecting a mechanic's lien will vary under state law and depend on the party asserting the lien and can involve several steps to perfect and enforce the lien.

a. In some states, as a preliminary step, subcontractors and suppliers have to give notice to the general contractor and project owner within a specified time to perfect and preserve their lien rights.

(i) For example, in Georgia, the project owner or their general contractor has to file a Notice of Commencement when work starts on the project.

(ii) A subcontractor/supplier, in turn, is required to provide a Notice to Contractor to the project owner or general contractor either within 30 days from the filing of the Notice of Commencement or 30 days following the first delivery of the labor/services/material to property (whichever is later). A subcontractor/supplier who fails to do this loses its lien rights. Ga. Code Ann. § 44-14-361.5(a).

b. Some states require a potential mechanic's lien claimant to file a verified statement of lien or memorandum with the local recording office, land records, or circuit court. *See* Va. Code Ann. §§ 43-4 to 43-5.

(i) As noted above, other states, such as Maryland, require the potential lien claimant to commence a lawsuit to perfect their lien rights. *See* Md. Code Ann., §§ 9-101, 9-104, 9-105

(ii) The timing for filing such statements, memorandums, and/or petitions also various from state, but generally the time period commences on the date that work is last provided to the project.

c. Some states require a mechanic's lien claimant to commence a lawsuit within in set period of time in order to continue the perfection of the lien. *See, e.g.,* Ga. Code Ann. § 44-14-361.1(a).

3. Priority Considerations. As with other aspects of a mechanic's lien, the lien claimant's priority vis-à-vis other lienholders and judgments will vary by state law and is dependent on several factors, including, whether the lien is inchoate and relates back, the scope of the priority vis-à-vis a construction lender, and the scope of the priority vis-à-vis similarly situated claimants.

C. The Automatic Stay: How Does it Impact the Creation and Perfection of Mechanic's Liens?

1. Section 362(a)(4) of the Bankruptcy Code applies to mechanic's liens, and specifically bars "any act to create, perfect, or enforce any lien against property of the estate." 11 U.S.C. § 362(a)(4).[3]

2. There is, however, an exception to Section 362(a)(4)'s prohibitions. Specifically, Section 362(b)(3) of the Bankruptcy Code provides that:

> The filing of a petition … does not operate as a stay … under [§ 362(a)], of any act to perfect, or to maintain or continue the perfection of an interest in property to the extent that the trustee's rights and powers are subject to such perfection under section 546(b) of this title or to the extent that such act is accomplished within the period provided under section 547(e)(2)(A) of this title.

3. Section 546(b), in turn, provides that –

> … [the] rights and powers of a trustee … are subject to any generally applicable law that (A) permits perfection of an interest in property to be effective against any entity that acquires rights in such property before the date of perfection, or (B) provides for the maintenance or continuation of perfection of an interest in property to be effective against any entity that acquires rights in such property before the date on which action is taken to effect such maintenance or continuation.

4. Whether a mechanic's lien claimant can take steps to <u>perfect</u>, <u>maintain</u>, or to **continue perfection** of their mechanic's lien will necessarily require the party to determine if the lien relates back to when the inchoate lien arose pre-petition. *Compare In re Linear Electric Co.*, 852 F.3d 313, 323 (3d Cir. 2017) *with In re Yobe Electric Inc.*, 728 F.2d 207 (3d Cir. 1984).

5. The exception to the automatic stay also <u>does not</u> apply to acts that require enforcement (*e.g.*, filing a foreclosure suit) to maintain the lien.

[3] Practitioners should be cognizant of when Section 108's tolling provisions apply and do not apply.

a. Section 546(b) addresses this issue as well:[4]

> If such [applicable nonbankruptcy] law requires seizure of such property or commencement of an action to accomplish such perfection … and such property has not been seized or such action has not been commenced before the date of the filing of the petition, such interest in such property shall be perfected … by giving notice within the time fixed by such law for such seizure or commencement.

b. The type of "notice" can vary from jurisdiction to jurisdiction.

(i) The most common method for satisfying the Section 546(b) notice requirements is by filing a *Notice of Perfection of Lien Under § 546(b)*. *See, e.g.*, *In re Baldwin Builders*, 232 B.R. 406, 413-14 (9th Cir. B.A.P. 1999).[5]

(ii) Requires the claimant to: (a) assert the claimant's right to a mechanic's lien under applicable law; (b) describe the property to which the lien attaches; (c) state the amount of the indebtedness secured by the lien; and (d) state that the claimant intends to assert and enforce the lien.

6. Tolling of Foreclosure Deadline – 11 U.S.C. § 108(c)

a. Section 108(c) tolls the deadline for a mechanic's lien claimant to commence a foreclosure (or other enforcement action), provided that the deadline has not expired before the petition date, to the later of: (i) the end of such period; or (ii) 30 days' notice of the termination or expiration of the automatic stay as to the claim. *See* 11 U.S.C. § 108(c).

b. Under section 108(c), a mechanic's lien claimant has 30 days from the termination of the automatic stay, *e.g.*, upon dismissal of the case, stay relief, or abandonment of the property, to commence the necessary actions. *See, e.g., In re 360 Networks (USA) Inc.*, 282 B.R. 756, 761-63 (Bankr. S.D.N.Y. 2001).

D. Other Considerations in Bankruptcy Concerning Mechanic's Lien Claimants' Rights.

1. Section 363 Sales "Free and Clear" of All Claims and Interests

[4] The legislative history provides that: "[t]he purpose of the subsection is to protect, in spite of the surprise intervention of a bankruptcy petition, those whom State law protects by allowing them to perfect their liens or interests as of an effective date that is earlier than the date of perfection." *See* S. Rep. No. 95-989, at 86 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6327.

[5] Some courts find that filing a secured proof of claim is sufficient, others have found that filing some other motion (*e.g.*, motion to prohibit the use of rent or seeking stay relief), is sufficient. *Compare In re Coated Sales, Inc.*, 147 B.R. 842, 846 (S.D.N.Y. 1992) *with In re Gelwicks*, 81 B.R. 445, 448 (Bankr. N.D. Ill. 1987).

a. A chapter 11 debtor may sell property "free and clear of any interest" only if the debtor satisfies one or more of the five requirements set forth under § 363(f). *See* 11 U.S.C. § 363(f)(1)-(5).

b. Those conditions are:

(i) "[A]pplicable nonbankruptcy law permits sale of such property free and clear of such interest." 11 U.S.C. § 363(f)(1)

(ii) With the impacted entity's consent. 11 U.S.C. § 363(f)(2).

(iii) The price that the property "is to be sold is greater than the aggregate value of all liens on such property." 11 U.S.C. § 363(f)(3).

(iv) The impacted lien is subject to "bona fide dispute." 11 U.S.C. § 363(f)(4).

(v) The entity "could be compelled, in a legal or equitable proceeding, to accept a money money satisfaction of such interest." 11 U.S.C. § 363(f)(5).

2. Lien Stripping – Chapter 7 Versus Chapter 11

a. In *Dewsnup v. Timm*, the U.S. Supreme Court held that a mechanic's lien can be stripped under Section 506(d) if the underlying claim is disallowed in its entirety. *See Dewsnup v. Timm*, 502 U.S. 410 (1992). The Supreme Court's decision, however, was limited to Chapter 7 cases.

b. In contrast, in a Chapter 11 case, the plan could potentially "strip" the lien by extinguishing the lien claimant's rights and re-vesting the property free and clear of all claims, liens and interests. *In re Northern New England Telephone Operations, LLC*, 795 F.3d 343 (2d Cir. 2015); *Universal Suppliers, Inc. v. Reg'l Bldg. Sys. (In re Reg'l Bldg. Sys., Inc.)*, 254 F.3d 528, 529, 532 (4th Cir. 2001).

PART TWO:
CONSTRUCTION ISSUES THAT MAY COME-UP DURING THE CASE

I. THIRD PARTY RELEASES

A. No Bankruptcy Jurisdiction or Authority to Grant Third-Party Releases

1. Although not a construction case, *In re Purdue Pharma, L.P.,* 635 B.R. 26, 90 (S.D.N.Y. 2021), certificate of appealability granted, No. 21 CV 7532 (CM), 2022 WL 121393 (S.D.N.Y. Jan. 7, 2022) is a recent case addressing the issue of a bankruptcy court's authority to grant third-party releases.

> "I conclude that the sections of the Code on which the learned Bankruptcy Judge explicitly relied, whether read separately or together, do not confer on any court the power to approve the release of non-derivative third-party claims against non-debtors, including specifically the Section 10.7 Shareholder Release that is under attack on this appeal. As no party has pointed to any other section of the Bankruptcy Code that confers such authority, I am constrained to conclude that such approval is not authorized by statute."

2. In a case related to the construction of a gold mine, the bankruptcy court does not have jurisdiction over third-party releases of non-debtors. *See In re Midway Gold US, Inc.,* 575 B.R. 475, 518 (Bankr. D. Colo. 2017).

> "The claims and disputes between the third-party non-debtors subject to Article IX.D are not, and would not be, cases brought under the Bankruptcy Code because neither the Releasing Parties nor the non-debtor Released Parties are debtors in these bankruptcy cases. Nor are the disputes between the non-debtor Releasing Parties and non-debtor Released Parties strictly "arising under" the Bankruptcy Code because the "Causes of Action and any other debts, obligations, rights, suits, damages, actions, remedies and liabilities" being released under Article IX.D are not limited to causes of action under the Bankruptcy Code, such as avoidance actions."

B. Yes, There is Bankruptcy Jurisdiction or Authority to Grant Third-Party Releases

1. *In re Kirwan Offs. S.a.r.l.,* 592 B.R. 489, 504 (S.D.N.Y. 2018), *aff'd sub nom. In re Kirwan Offs. S.a.R.L.*, 792 F. App'x 99 (2d Cir. 2019) ("A bankruptcy court acts pursuant to its core jurisdiction when it considers the involuntary release of claims against a third-party, non-debtor in connection with the confirmation of a proposed plan of reorganization, which is a statutorily-defined core proceeding. 28 U.S.C. § 157(b)(2)(L). A confirmed reorganization plan that includes such releases does not address the merits of the claims being released; those, of course, are governed by non-bankruptcy law. Rather, it effectively cancels those claims so as to permit a total reorganization of the debtor's affairs in a manner available only in bankruptcy.")

a. The *Purdue Pharma* court differentiated *Kirwin* by noting that the *Kirwin* court "did not analyze whether there was a statutory (as opposed to a jurisdictional or constitutional) basis for the injunction that was at issue in that case. Indeed, no statutory argument was made." 635 B.R. at 89

2. *In re Hercules Offshore, Inc.*, 565 B.R. 732, 764 (Bankr. D. Del. 2016) (third-party releases approved by bankruptcy court); *see also In re Boy Scouts of Am. & Delaware BSA, LLC*, 642 B.R. 504, 674 (Bankr. D. Del. 2022) (approving third party releases).

II. EXECUTORY CONTRACTS

A. Sureties Issues

1. Are Surety Bonds Executory?

a. No. *Matter of Falcon V, L.L.C.*, 44 F.4th 348 (5th Cir. 2022)

(i) Facts: The debtor was in oil and gas exploration. Its surety issued 4 non-cancellable bonds in the aggregate amount of $10.6 million. The bonds were non-cancellable even in the event the debtor failed to comply with its obligations to the surety. The debtor also executed an indemnity agreement agreeing to pay the bond premiums and to indemnify the surety for any payments made under the bonds. The debtor filed for chapter 11. The surety filed a $10.6 million partially secured, partially general unsecured claim proof of claim. In the proof of claim, the surety stated that bonds could not be assumed because they were financial accommodations. The bankruptcy court approved the debtor's chapter 11 plan of reorganization. The plan provided for blanket assumptions of executory contracts but did not specifically say it was assuming the surety's bond program. The plan also expressly identified the executory contracts it was rejected, and the surety's bond program was not identified in the schedule of rejected contracts. Post-confirmation, the debtor missed premium payments on 2 of the 4 bonds. In response, based on its rights under the indemnity agreement, the surety demanded that the reorganized debtor either obtain a release of the bonds, or provide additional collateral security so that the surety was fully secured. The reorganized debtor responded arguing that the surety violated the discharge injunction by seeking to collect and enforce discharged obligations and sought punitive damages against the surety. The surety responded asserting that the debtor's indemnity obligations and the overall surety bond program had been assumed under the plan.

(ii) Bankruptcy Court Holding: The bankruptcy court held the surety bond program is not an executory contract capable of assumption because the surety already posted the non-cancellable bonds and owed a future performance to the bond obligee, not to the debtor. Further, even if the surety bond program was an executory contract, it was by the surety's own statements, a financial accommodation that could not be assumed.

(iii) Fifth Circuit's Holding: Affirming the bankruptcy and district court's ruling, the Fifth Circuit acknowledged that under the Countryman Test a flexible approach must be adopted when construing multiparty contracts. *Id.* at 350. ("However, we do agree with Argonaut that courts should apply the Countryman test to multiparty contracts in a flexible manner that accounts for the various obligations owed to all of the parties, rather than focusing exclusively on the flow of obligations between the debtor and the creditor. . . . Accordingly, when applying the Countryman test to this case, we consider not just the obligations that Falcon V and Argonaut owe to each other but also their respective obligations to the third-party obligees.”).

(a) The Fifth Circuit thus held that surety bond program was not executory because once the bonds were posted, the surety did not have any continuing obligations. Further, the nature of the bonds being non-cancellable did not change their nature from non-executory to executory.

(b) The Fifth Circuit also reject the surety’s “pass-through” argument (*e.g.*, not assumed or rejected) because to “pass-through” the contracts must be executory.

b. Yes. *In re Evans Products Co.*, 91 B.R. 1003 (Bankr. S.D. Fla. 1988), which found that a surety bond program was an executory contract and assumable because the debtor had ongoing obligations to: (a) pay bond premiums; (b) maintain records, file reports, and accept, investigate, and adjust or litigate all claims; and (c) and indemnify the surety. The surety, in turn, had ongoing obligations to the debtor to perform under the bonds.

2. Can a Surety Terminate its Bonds Post-petition?

a. Yes, but the surety may need to seek stay relief.

(i) *See Matter of Edwards Mobile Home Sales, Inc*., 119 B.R. 857, 860 (Bankr. M.D. Fla. 1990) (“This Court agrees with the holdings in both *Wegner* and *Computer Communications* and finds Ohio Casualty may not terminate the surety bond without first obtaining relief from the automatic stay. While Section 365(e)(2) authorizes Ohio Casualty's termination of the surety bond, it does not eliminate the requirement of obtaining relief from the stay pursuant to Section 362(d). If Section 365(e)(2) was sufficient in itself to allow the termination, then effectively it would create an exception to the automatic stay outside of those already specifically delineated in the code. The Court does not find Section 365(e)(2) exempts non-assumable executory contracts from the scope of the automatic stay. Based on the above stated reasons the Court finds Ohio Casualty by virtue of its “cancellation notice” of Debtor's surety bond violated the automatic stay.”). *See, e.g., In re Advent Corp.*, 24 B.R. 612, 614 (1st Cir. 1982) (requiring relief from stay to cancel surety bond); *In re Wegner Farms Co.*, 49 B.R. 440, 442 (Bankr. Iowa 1985) (requiring relief from stay to cancel surety bond); *In re Security Gas & Oil, Inc.*, 70 B.R. 786, 791 (Bankr. N.D. Cal. 1987) (same).

(ii) *But see Watts v. Pennsylvania Housing Finance Co.*, 876 F.2d 1090, 1096 (3d Cir. 1989) (non-surety case but holding that a party to a financial accommodation contract may terminate the contract without first seeking stay relief).

b. No.

(i) *See In re Maxon Eng'g Servs., Inc.* (Bankr. D.P.R. 2005) ("Unlike most contracts, default by the Debtor under the surety bonds does not give the Movant the right to terminate the bonds but instead triggers the Movant's obligation to pay or perform. The risky nature of the construction industry creates the need for some guaranty that the construction job will be completed and paid for. T. Scott Leo, The Construction Contract Surety and Some Suretyship Defenses, 34 Wm. & Mary L.Rev. 1225, 1228 (1993). If the surety bonds could be terminated upon the principal's bankruptcy filing, that defeats the purpose of the surety bond. Since the Movant is not permitted to terminate the surety bonds under § 365(e)(2), the Movant's motion for relief for the purpose of terminating the surety bonds is denied."); *see also In re All Phase Elec. Contracting, Inc*., 409 B.R. 272, 274 (Bankr. D. Conn. 2009) (finding the surety bonds were not executory under Countryman definition).

B. Does the Automatic Stay Prevent Collection on a Bonded Claim?

1. *In re Hollister Constr. Servs., LLC*, 617 B.R. 45, 57 (Bankr. D.N.J. 2020) ([A]ny party who files a post-petition lien, or who attempts to enforce a pre-petition lien, **or who attempts to collect on a bonded claim violates the stay**. However, to the extent the Subcontractors seek state law remedies against a non-debtor property owner that do not affect the bankruptcy estate—such as quantum meruit or unjust enrichment claims—there is no stay violation.") (emphasis added)

a. Reasoning: "Where a surety performs or pays a subcontractor to perform pursuant to a bond, the 'surety has an 'equitable lien' against the identifiable proceeds of the underlying contract.' *In re Alcon Demolition, Inc*., 204 B.R. 440, 447 (Bankr. D.N.J. 1997) (*citing Pearlman v. Reliance Ins. Co*., 371 U.S. 132, 137, 83 S. Ct. 232, 235, 9 L. Ed. 2d 190 (1962)). In this case, [surety] did not make any pre-petition payments to the Subcontractors on the bonds; therefore, it had no pre-petition rights in the Debtor's accounts receivable. If the Subcontractors were to now collect on any bonds issued, [subcontractor] would become entitled to an equitable lien on the Debtor's accounts receivable."

2. *In re Calpine Corp.,* 354 B.R. 45, 50 (Bankr. S.D.N.Y. 2006), aff'd, 365 B.R. 401 (S.D.N.Y. 2007) (litigation against surety could not proceed outside of bankruptcy because it would expose the debtor to "a significant risk of collateral estoppel, stare decisis and evidentiary prejudice. If judgment is entered against [surety], [debtor] must indemnify it thereby having an adverse impact upon property of the Debtors' estates. Moreover, continuation of the case will distract key personnel from [debtor's] reorganization efforts including [debtor's] sole remaining transmission engineer.").

C. Subrogation Rights

1. *In re LTC Holdings, Inc.*, 597 B.R. 565, 567 (Bankr. D. Del. 2019), aff'd, No. AP 15-51889 (CSS), 2020 WL 5576850 (D. Del. Sept. 17, 2020), aff'd sub nom. *In Re LTC Holdings, Inc.*, 10 F.4th 177 (3d Cir. 2021) ("Subrogation allows a surety to step into the shoes of its obligee. However, subrogation need not permit the surety to step into these shoes when an obligee is still wearing them.) (addressing a dispute over the rights to a tax refund and finding that debtors' surety on government construction projects was not equitably subrogated to government's setoff rights).

2. *In re J.B. Const. Co., Inc.*, No. BK 10-80880-TJM, 2011 WL 830101, at *2 (Bankr. D. Neb. Mar. 4, 2011) ("[T]he long-standing general rule is that the surety that makes payment on claims against the construction project is equitably subrogated to the rights of the contractor to receive any contract retainage and is equitably subordinated to the owner which had rights of setoff and other rights vis-à-vis the contractor and the claimants. . . . conflicts between the rights of sureties and the rights of third parties must be resolved outside of Article 9, where **sureties generally prevail over banks with perfected Article 9 security interests**.") (emphasis added).

3. *In re Jones Constr. & Renovation, Inc.*, 337 B.R. 579 (Bankr. E.D. Va. 2006) (holding that the surety's rights of subrogation allowed it to step ahead of the chapter 7 trustee to recover contract funds on a bonded contract).

III. SET-OFF AND RECOUPMENT RIGHTS AND DEFENSES

A. Overview

1. The doctrines of setoff and recoupment may provide grounds for the owner or general contractor to defend against a turnover action and obtain the bankruptcy court's permission to withhold contract funds from collection by the debtor-in-possession or trustee. Generally speaking, setoff is an equitable right of a creditor to deduct a debt it owes to the debtor from a claim it has against the debtor arising out of a separate transaction. Further, for setoff to be permitted, both debts must arise prepetition or postpetition. In other words, a claim which arises prepetition may be setoff only against a credit which also arises prepetition. *See, e.g., Braniff Airways v. Exxon*, 814 F.2d 1030 (5th Cir. 1987); *Reich v. Davidson Lumber Sales Emp. Ret. Plan*, 154 B.R. 324, 335 (D. Utah 1993). Recoupment does not require that both claims be prepetition or that both be postpetition but requires the opposing claims must arise from the same transaction. *See, e.g.*, 4 Lawrence P. King, Collier on Bankruptcy ¶ 553.03 (15th ed. 1991).

2. Importantly, the Bankruptcy Code is not an independent source of law that authorizes setoff or recoupment; it recognizes and preserves rights that exist under non-bankruptcy law. *See, e.g., Butner v. United States*, 440 U.S. 48 (1979), Therefore, a creditor seeking to setoff or recoup a debt must establish a claim and a right to do so under state or federal law. *See In re Dillard Ford, Inc.*, 940 F.2d 1507, 1512 (11th Cir. 1991); *In re Public Serv. Co.*, 884 F.2d 11 (1st Cir. 1989); *Durham v. SMI Indus.*, 882 F.2d 881 (4th

Cir. 1989); *In re Pieri*, 86 B.R. 208 (Bankr. 9th Cir. 1988); *United States v. Norton*, 717 F.2d 767 (3d Cir. 1983); *In re McLean Indus.*, 90 B.R. 614 (Bankr. S.D.N.Y. 1988).

3. Both setoff and recoupment can be affirmative defenses or counterclaims. Outside of bankruptcy the distinction is usually not significant. In bankruptcy, however, the distinction can be important. For example, the Bankruptcy Code codifies and governs setoff but is silent as to recoupment. *See, e.g, In re B&L Oil*, 782 F.2d 155 (10th Cir. 1986); 11 U.S.C. § 553. Most significantly, setoff is available in bankruptcy only when both the opposing claims arise on the same side of the time line described by the petition's filing; (i.e., both must be prepetition claims or both must be postpetition claims). Recoupment is not so limited. *See generally Lee v. Schweiker*, 739 F.2d 870 (3d Cir. 1984).

B. Setoff.

1. The doctrine of setoff gives a creditor the right to offset a mutual debt owing by such creditor to the debtor provided that "both debts arose before commencement of the bankruptcy action and are in fact mutual." *See. e.g., In re Univ. Med. Ctr.*, 973 F.2d 1065, 1079 (3d Cir. 1992).

a. Mutuality as to parties is strictly construed i.e., both obligations are held by the same parties, in the same right or capacity, and both arise either prepetition or postpetition). 11 U.S.C. § 553(a); *In re Davidovich*, 901 F.2d 1533, 1537 (10th Cir. 1990); *In re Public Serv. Co.*, 884 F.2d 11 (1st Cir. 1989); *In re Bay State York Co.,* 140 B.R. 608, 613 (Bankr. D. Mass. 1992); *In re Mastroeni*, 57 B.R. 191 (Bankr. S.D.N.Y. 1986); 4 Collier on Bankruptcy ¶ 553.04. Section 542(b) of the Bankruptcy Code, which authorizes the collection of accounts receivable, does not apply "to the extent that such debt may be offset under section 553 [of the Bankruptcy Code]."

b. Importantly, triangular setoffs are not permissible because they do not satisfy the requirement of mutuality. *See, e.g., In re Orexigen Therapeutics, Inc.*, 990 F.3d 748 (3d Cir. 2021).

c. Nor can a bankruptcy court grant setoff on equitable grounds without mutuality. *See e.g., Boston & Maine Corp. v. Chicago Pacific Corp.*, 785 F.2d 562 (7th Cir. 1986).

2. Section 553 preserves rights that exist under nonbankruptcy law to offset a claim that a creditor has against the debtor to reduce a debt it owes to the debtor. The exercise of setoff during the pendency of a bankruptcy case is subject to certain limitations.

a. First, the setoff is stayed by 11 U.S.C. § 362(a)(7). Permission of the bankruptcy court must be obtained before making a setoff, but the creditor need not have obtained stay relief before asserting setoff as a defense to the demand for turnover of progress payments or retainage. *In re Charter Co.*, 86 B.R. 280 (Bankr. M.D. Fla. 1988). *See also In re Fulghum Construction Corp.*, 23 B.R. 147 (Bankr. M.D. Tenn. 1982) (explaining that creditor need not file proof of claim to assert its right of setoff, and that stay does not destroy right to setoff).

b. Second, setoff is permitted only with respect to “mutual debts,” when each party owes a debt directly to the other, in the same right, and between them in the same capacity. *In re Bay State York Co.*, 140 B.R. 608 (Bankr. D. Mass. 1992); 11 U.S.C. § 553(a).

c. Third, both the debt owed to the debtor and the debt owed to the creditor must have arisen “before the commencement of the case.” 11 U.S.C. § 553(a).

3. Additionally, to prevent trafficking in claims for the purpose of defeating the estate's collection efforts, setoff may be prohibited when the debt owed by the creditor to the debtor was incurred within 90 days before bankruptcy “for the purpose of obtaining a right of setoff,” or when the claim against the debtor was acquired from a third party for the same purpose. 11 U.S.C. §§ 553(a)(2)-(a)(3); *See also In re Bay State York Co.* (surety permitted to set off obligations it owed debtor/general contractor to extent of subcontractor's claims paid by surety).

4. Because debts arising from different transactions between the parties may be offset, contract funds due a debtor/subcontractor on one project may be set off against claims by the party owing the money arising from other projects. If the projects are closely related and intertwined, and the contracts were executed at the same time and are cross-defaulted, setoff may not be available. A post-petition debt, however, cannot be offset against a prepetition claim; there is no mutuality, because a debtor-in-possession is an entity distinct from the debtor. *See, e.g., In re Virginia Block Co.*, 16 B.R. 771 (W.D. Va. 1982).

5. Under 11 U.S.C. § 365(g)(1), if the debtor-in-possession has not assumed an executory contract with court approval and, later in the Chapter 11 case, rejects the contract, the rejection is deemed to be the equivalent of a prepetition breach, thus making any damages a prepetition claim. *But see In re Fordson Engineering Corp.*, 25 B.R. 506 (Bankr. E.D. Mich. 1982) (offsetting post-petition claims and damages).

a. If the debtor continues to work on a project after filing for bankruptcy relief, the contract funds earned post-petition cannot be offset against a damage claim if the contract is not assumed by the estate and the debtor later defaults. Rejection does not terminate the contract as a matter of law. *In re MMH Automotive Group, LLC*, 385 B.R. 347 (Bankr. S.D. Fla. 2008).

C. Recoupment.

1. When setoff would not be available, recoupment may provide an important alternative defense to an action seeking the turnover of accounts receivable. *See, e.g, In re Ruiz, 146 B.R. 877* (Bankr. S.D. Fla. 1992) (distinguishing between elements of setoff and recoupment).

a. “Recoupment allows a defendant to reduce the amount of a plaintiff's claim by asserting a claim against the plaintiff which arose out of the same transaction to arrive at a just and proper liability on the plaintiff's claim.” *In* *re Clowards, Inc.*, 42 B.R. 627, 628 (Bankr. D. Idaho 1984). *See also In re Gem Construction Corp. of Virginia*, 262 B.R. 638 (Bankr. E.D. Va. 2000); *Gold Leaf Corp. v. Hamilton Projects, Inc.*, 78 B.R. 1018 (Bankr. N.D. Fla. 1987).

2. Unlike setoff, the automatic stay cannot bar recoupment. *See In re Visiting Nurse Ass'n of Tampa Bay, Inc.,* 121 B.R. 114 (Bankr. M.D. Fla. 1990).

a. An illustrative example is *In re Clowards, Inc.*, in which the Chapter 7 trustee sought to recover from prime contractors the amounts due under contracts that the debtor/subcontractor had entered into, and later defaulted on, in an earlier Chapter 11 case. The prime contractors sought to reduce the amounts due by the amount of their damages arising from the debtor's defaults, either by setoff or recoupment. The court found setoff unavailable for lack of mutuality; i.e., because of the conversion of the case to Chapter 7, the damage claims were considered prepetition, whereas the debt was a post-petition asset of the estate. Although a setoff did not apply, the doctrine of recoupment did. *See also In re B & L Oil Co.*, 782 F.2d 155 (10th Cir. 1986) (setoff was inappropriate because prepetition and post-petition claims lack mutuality, but recoupment was applicable); *In re Midwest Service & Supply Co.*, 44 B.R. 262, 265 (D. Utah 1983) ("The automatic stay prevents pre-petition obligations from being set off against post-petition obligations. There is no similar restriction in the case of recoupments.").

3. Every contractual default by the debtor, including a failure to pay subcontractors or suppliers, may not, by itself, be sufficient to prevent collection of contract funds for the bankruptcy estate.

a. The bankruptcy court has broad discretion to deny setoff or recoupment on equitable grounds. *In re University Medical Ctr*, 973 F.2d 1065 (3d Cir. 1992), superseded by statute on other grounds 11 U.S.C. § 362.

b. Several decisions suggest that setoff will be permitted only when the owner or general contractor faces actual damages if the funds are paid to the estate. *See generally In re Central States Mechanical, Inc.*, 2011 WL 1637991 (Bankr. D. Kan. 2011) (calculating actual damages resulting from subcontractor's breach to determine amount of setoff to which general contractor was entitled).

4. Only those claims that the owner or general contractor has a direct obligation to pay, such as the claims of construction lienors or completion costs, may be available for setoff. *In re Flanagan Bros., Inc.*, 47 B.R. 299 (Bankr. D. N.J. 1985).

a. In *Flanagan*, the prime contractor, under applicable state law, had the responsibility of a surety to the debtor's unpaid suppliers and sought relief from the automatic stay to setoff the amounts owed to the debtor's unpaid suppliers against the contract balance otherwise owed to the debtor. The court premised its decision to permit setoff in this Chapter 7 proceeding on the prime contractor's statutory obligation to pay the suppliers and the "pay twice" liability that the prime contractor faced. The court held that setoff would be permitted to avoid an inequitable result. *See also Bel Marin Driwall, Inc. v. Grover*, 470 F.2d 932 (9th Cir. 1972) (under Bankruptcy Act, court upheld right of prime contractor to set off contract funds owed to debtor/ subcontractor against amount contractor had paid to debtor's unpaid suppliers, under obligations arising under state law).

b. The claims of other suppliers and subcontractors who have failed to perfect construction liens, and whom the owner or prime contractor has no enforceable obligation to pay, may not be recognized as a basis for the setoff of contract funds. *See In re Scherer Hardware & Supply, Inc.*, 9 B.R. 125, 129 (Bankr. N.D. Ill. 1981) (when prime contractor has already paid one of debtor's unpaid suppliers who had not properly perfected lien, "setoff should not be allowed if the payment [was] made voluntarily and without compulsion"). *Compare Tucson House Construction Co. v. Fulford*, 378 F.2d 734 (9th Cir. 1967) (prime contractor denied setoff when it had purchased claim with view to use it as setoff, and liability for claim was only remote and contingent), *with In re LaFollette Sheet Metal, Inc.*, 35 B.R. 634 (Bankr. E.D. Tenn. 1983) (prime contractor's prepetition payments to debtor's unpaid suppliers, who had failed to comply with procedure to perfect construction liens, could be set off or recouped if contract with debtor included covenants requiring that all project claims be paid).

PART THREE:
HOW AVOIDANCE ACTIONS PLAY INTO CONSTRUCTION LAW

I. PREFERENCE ACTIONS AND DEFENSES.

A. Section 547 of the Bankruptcy Code provides in relevant part as follows:

(b)Except as provided in subsections (c), (i), and (j) of this section, the trustee may, based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c), avoid any transfer of an interest of the debtor in property—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547.

B. In addition to the plaintiff's requirement that it satisfy its burden as to the *prima facie* preference case, preference defendants frequently assert a number of affirmative defenses, each of which is expressly set forth in 11 U.S.C. § 547(c), including (i) substantially contemporaneous new value (§ 547(c)(1)); (ii) ordinary course of business (§ 547(c)(2)); and (iii) subsequent new value (§ 547(c)(4)).

II. SURETIES AND PREFERENCES.

A. Subcontractor's release of claim against bond only constituted new value to extent that surety is secured. *See In re JWJ Contracting Co., Inc.*, 287 B.R. 501, 513 (B.A.P. 9th Cir. 2002), aff'd, 371 F.3d 1079 (9th Cir. 2004).

B. Surety can be sued for preference if it was a creditor and received value from debtor in 90 days before bankruptcy. *See In re E-Z Serve Convenience Stores, Inc.*, 377 B.R. 491, 497 (Bankr. M.D.N.C. 2007) ("Based upon the plain language of the Bankruptcy Code, as well as the relevant case law, the court concludes that [Surety] was a creditor at the time of the Transfer. [Surety] was obligated to pay any claims made by obligees under the bonds as the Debtor's surety. The Debtor, in turn, was obligated to indemnify [Surety] for any such payments. As a result, [Surety] had a contingent claim against the Debtor for reimbursement that became fixed if and when a claim was made against a bond. As an entity that had a claim against the Debtor, [Surety] was a creditor.").

III. MECHANIC'S LIENS AND PREFERENCE ACTIONS.

A. The ability to avoid a mechanic's lien once again is dependent, in part, on applicable non-bankruptcy law. *See* 11 U.S.C. §§ 546(b), 547(c)(6).

B. Inchoate liens as new value and/or not causing the defendant to receive more than it otherwise would have:

1. As it relates to preferences against contractors and materialmen, in particular, preference defendants frequently assert that the payments received during the preference period are not subject to avoidance because, but for the payment, the defendant would have had a lien under applicable state law. Whether couched as an affirmative defense under Section 547(c) because the defendant provided new value to the debtor through the waiver of lien rights, or based upon the fact that, but for the transfer, the defendant would have had a secured claim due to its inchoate lien rights, and therefore, the contractor or materialman would not have received more than it otherwise would have had the transfer not been made.

2. There is a split in authority whether a release of inchoate lien rights provides "new value," to the debtor. *See, e.g., Nordberg v. Arab Banking Corp. (In re Chase & Sanborn Corp.)*, 904 F.2d 588, 596 (11th Cir.1990); *In re Cocolat, Inc.*, 176 B.R. 540, 548 (Bankr. N.D. Cal.1995); *Cimmaron Oil Co., Inc. v. Cameron Consultants, Inc.*, 71 B.R. 1005, 1009 (N.D. Tex. 1987), *Ragsdale v. M & M Elec. Supply, Inc. (In re Control Elec., Inc.)*, 66 B.R. 624, 626-27 (Bankr. N.D.Ga. 1986); *Tidwell v. Bethlehem Steel Corp. (In re Georgia Steel, Inc.)*, 56 B.R. 509, 522 (Bankr. M.D.Ga. 1985); *but see Simon v. Engineered Protection Sys., Inc. (In re Hatfield Elec. Co.)*, 91 B.R. 782, 786 (Bankr. N.D. Ohio 1988); *Mason and Dixon Lines, Inc. v. St. Johnsbury Trucking Co. (In re Mason and Dixon Lines, Inc.)*, 65 B.R. 973, 979 (Bankr. M.D.N.C. 1986); *La-Rose v. Crosby & Son Towing, Inc. (In re Dick Henley, Inc.)*, 38 B.R. 210, 214 (Bankr. M.D.La. 1984); *In re GEM Construction Corp. of Virginia*, 262 B.R. 638 (Bankr. E.D.Va. 2000); *O'Rourke v. Seaboard Surety Co. (In re E.R. Fegert Inc.)*, 887 F.2d 955 (9th Cir. 1989) (subcontractors' release of claims against surety bond provided new value to the debtor); *The Liquidation Committee v. Binsky & Snyder Inc. (In re J.A. Jones Inc.)*, 361 B.R. 94 (Bankr. W.D.N.C. Jan. 16, 2007) (finding that a release of inchoate lien rights can provide new value under the "indirect transfer" theory). *But see Precision Walls v. Crampton*, 196 B.R. 299, 303 (E.D.N.C. 1996) (Determining that holders of unperfected mechanic's liens not entitled to secured status); *Lewis v. Custom Heating Co. (In re Joseph M. Eaton Builders, Inc.)*, 84 B.R. 56, 58-9 (Bankr. W.D. PA 1988) (same); *Schoonover Electric Co., Inc. v. Enron Corp. (In re Enron)*, 294 B.R. 232, 239 (Bankr. S.D.N.Y. 2003) (lien avoidable in bankruptcy); and *In re RDM Sports Group, Inc.*, 205 B.R. 805, 815 (N.D. Ga. 2000).

3. Other decisions have analyzed the transfer in the context of whether the transfer would have caused the defendant to receive more than it otherwise would have had the payments not been made. *See, e.g., Bryant v. JCOR Mech., Inc. (In re Electron Corp.)*, 336 B.R. 809 (10th Cir. BAP 2006) (holding that payments to materialmen do not constitute avoidable preferences where: (a) at the time of payment, the materialman could have perfected a mechanic's lien had the materialman not been paid; and (b) the lien, if perfected, would not have been avoidable by the trustee under 11 U.S.C. § 545); *Official Committee of Unsecured Creditors of 360 Networks (USA) Inc. v. AAF-McQuay Inc. (In re 360Networks (USA) Inc.)*, 327 B.R. 187 (Bankr. S.D.N.Y. 2005) (holding that payment in satisfaction of an inchoate lien is not an avoidable preference where perfection of the lien would not have been avoidable). *See also Johhnson Mem'l Hosp. Inc. v. New England Radiator Works (In re Johnson Mem'l Hospital, Inc.)*, 470 B.R. 119 (Bankr. D. Conn. 2012); *Matter of Alkap, Inc.*, 54 B.R. 151 (Bankr. D.N.J. 1984); *Liquidating Trust v. Mo-Tech Corp. (In re E.D.C. Liquidating, Inc.)*, 2017 WL 499883 (Bankr. N.D. Ohio Feb. 7, 2017); *In re Golfview Developmental Ctr., Inc.*, 309 B.R. 758, 769 (Bankr. N.D. Ill. 2004); *In re Carney*, 396 B.R. 22 (Bankr. N.D. Iowa 2008); *Greenblatt v. Utley*, 240 F.2d 243 (9th Cir.1956); *Hopkins v. Merlins Insulation, LLC (In re Larsen)*, 2008 WL 4498890 (Bankr. D. Idaho 2008); *But see, Precision Walls, Inc. v. Crampton*, 196 B.R. 299 (E.D.C.C. 1996); *In re Joseph M. Eaton Builders, Inc.*, 84 B.R. 56 (Bankr. W.D. Pa. 1988).

IV. Payments not property of the estate

There is an issue whether the payment s received were property of the estate. As noted above, some, but not all states have specific trust fund statues. Applying a broad concept of property of the estate, bankruptcy courts in non-trust-fund states have found that contract funds due to a debtor that is a contractor, subcontractor, or supplier may or may not be property of the bankruptcy estate. *Compare Keenan Pipe & Supply Co. v. Shields*, 241 F.2d 486 (9th Cir. 1956) (holding that a check may not be property of the estate because parties relied on debtor to transfer funds for statutory obligation) *with In re Buono*, 119 B.R. 498 (Bankr. W.D. Pa. 1990) (different result if debtor payee had economic interest in joint check). *See also In re Collman & Karsky Architects, Inc.*, 460 B.R. 810 (Bankr. M.D. Fla. 2011) (finding that undisbursed contract proceeds are property of estate on basis that trustee avoided subcontractor's lien because it was not timely perfected).

V. Earmarking doctrine

The earmarking doctrine relates to property held in trust by the debtor for the benefit of another. *The Official Comm. Of Unsecured Creditors of Cox & Schepp, Inc. v. Palmer Elec. Co. (In re Cox & Schepp, Inc.)*, 523 B.R. 511 (Bankr. W.D.N.C. 2014). Where a third party lends money to a debtor for the sole purpose of repaying a specific debt to a specific creditor, the money never becomes property of the debtor's estate. *In re Ameripay, LLC*, 2012 WL 246397 (Bankr. D.N.J. Jan. 25, 2012); *Lain v. Universal Drywall LLC (In re Erickson Ret. Cmtys., LLC)*, 497 B.R. 504 (Bankr. N.D. Tex. 2013). For a defendant to successfully assert the earmarking doctrine in defense to a preference actin, it must be able to show that the funds at issue were specifically designated for the creditor for this defense to apply. *McCuskey v. National Bank of Waterloo (In re Bohlen Enters., Ltd.)*, 859 F.2d 561 (8th Cir. 1988).

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