

B A N K R U P T C Y

Construction Claims in Bankruptcy

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Bankruptcy Basics

- Types of Bankruptcy
- Basic Debtor Protection Concepts
- Meeting of Creditors
- Debtor's Schedules
- Types of Claims

Bankruptcy Basics: Types of Bankruptcy

- **Chapter 7** – Liquidation of business or person’s assets, if any. “No asset” cases are common.
- **Chapter 9** – Municipalities.
- **Chapter 11** - Permits a person or business to reorganize while obtaining protection from its creditors. Typically ends with a plan.
- **Chapter 12** – Family farmers.
- **Chapter 13** – Reorganization for individuals.
- **Chapter 15** – Foreign bankruptcies. Foreign bk debtor also files here.

Bankruptcy Basics: Debtor Protections

- **The Automatic Stay** - Created immediately upon filing of any bankruptcy. Prohibits all sorts of collection activity.
- **Moratorium on Paying Some Debts** – in Ch. 11, the debtor usually does not have to pay unsecured creditors until a plan is approved and only then do they have to pay them pursuant to the plan.
- **Discharge of Debts** – Some debts may be discharged in bankruptcy.

Bankruptcy Basics: Meeting of Creditors

Meeting of Creditors

- What is it?
- Who can attend?
- What can you ask?



Bankruptcy Basics: Debtor's Schedules

Official Form 206A/B

Schedule A/B: Assets — Real and Personal Property

12/15

Disclose all property, real and personal, which the debtor owns or in which the debtor has any other legal, equitable, or future interest. Include all property in which the debtor holds rights and powers exercisable for the debtor's own benefit. Also include assets and properties which have no book value, such as fully depreciated assets or assets that were not capitalized. In Schedule A/B, list any executory contracts or unexpired leases. Also list them on *Schedule G: Executory Contracts and Unexpired Leases* (Official Form 206G).

Be as complete and accurate as possible. If more space is needed, attach a separate sheet to this form. At the top of any pages added, write the debtor's name and case number (if known). Also identify the form and line number to which the additional information applies. If an additional sheet is attached, include the amounts from the attachment in the total for the pertinent part.

For Part 1 through Part 11, list each asset under the appropriate category or attach separate supporting schedules, such as a fixed asset schedule or depreciation schedule, that gives the details for each asset in a particular category. List each asset only once. In valuing the debtor's interest, do not deduct the value of secured claims. See the instructions to understand the terms used in this form.

Part 1: Cash and cash equivalents

1. Does the debtor have any cash or cash equivalents?

- No. Go to Part 2.
 Yes. Fill in the information below.

All cash or cash equivalents owned or controlled by the debtor

Current value of debtor's interest

2. Cash on hand

\$ _____

3. Checking, savings, money market, or financial brokerage accounts (*Identify all*)

Name of institution (bank or brokerage firm) Type of account Last 4 digits of account number

3.1. _____ \$ _____

3.2. _____ \$ _____

4. Other cash equivalents (*Identify all*)

4.1. _____ \$ _____

4.2. _____ \$ _____

5. Total of Part 1

\$ _____

Add lines 2 through 4 (including amounts on any additional sheets). Copy the total to line 80.

Schedules:

A/B—Real and Personal Property

C—Exemptions

D—Secured Claims

E/F—Unsecured Claims (priority + nonpriority)

G—Executory Contracts and Expired Leases

H—Co-debtors

Bankruptcy Basics: Types of Claims

The *type* of claim matters:

- Debtor may object to a claim or amount of a claim pursuant to an objection
- Dictates whether it is dischargeable or not
- Determine priority of claim and therefore amount of payment
- May determine who owns certain property (e.g., trust funds)

Making a Claim

The Process

- File a Proof of Claim – Very simple. The process and deadline are critical.
- The deadline - Often announced in the notice setting the meeting of creditors.
- Secured versus unsecured?

Part 2: Give Information About the Claim as of the Date the Case Was Filed

6. Do you have any number you use to identify the debtor? No
 Yes. Last 4 digits of the debtor's account or any number you use to identify the debtor: _____

7. How much is the claim? \$ _____ Does this amount include interest or other charges?
 No
 Yes. Attach statement itemizing interest, fees, expenses, or other charges required by Bankruptcy Rule 3001(c)(2)(A).

8. What is the basis of the claim? Examples: Goods sold, money loaned, lease, services performed, personal injury or wrongful death, or credit card.
Attach redacted copies of any documents supporting the claim required by Bankruptcy Rule 3001(c).
Limit disclosing information that is entitled to privacy, such as health care information.

9. Is all or part of the claim secured? No
 Yes. The claim is secured by a lien on property.
Nature of property:
 Real estate. If the claim is secured by the debtor's principal residence, file a *Mortgage Proof of Claim Attachment* (Official Form 410-A) with this *Proof of Claim*.
 Motor vehicle
 Other. Describe: _____
Basis for perfection: _____
Attach redacted copies of documents, if any, that show evidence of perfection of a security interest (for example, a mortgage, lien, certificate of title, financing statement, or other document that shows the lien has been filed or recorded.)
Value of property: \$ _____
Amount of the claim that is secured: \$ _____
Amount of the claim that is unsecured: \$ _____ (The sum of the secured and unsecured amounts should match the amount in line 7.)
Amount necessary to cure any default as of the date of the petition: \$ _____
Annual Interest Rate (when case was filed) _____ %
 Fixed
 Variable

Types of Claims

Common Construction Claims

- Constitutional Lien – secured.
- Statutory Lien – secured.
- Mineral Lien – secured
- Contract claim – unsecured.
- Trust fund claim – unsecured.

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6. Do you have any number you use to identify the debtor? No
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Secured Claims

Why Do Secured Claims Matter?

- Limited pool of funds/assets
- Priority

How Do you get a Secured Claim?

- UCC Financing Statement
- **Record a lien**

Types of Liens

1. Mechanic's and Materialmen's Liens—Commercial Construction

- Constitutional – Available to only Original Contractor
- Statutory – Available to both Original Contractor & Subcontractors

2. Mineral Liens—Pipelines and Oil and Gas Wells

WE THE PEOPLE
insure domestic Tranquility, provide for the common defence
and our Posterity, do ordain and establish this Constitution

Article I.
All legislative Powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.

The House of Representatives shall be composed of Members chosen every second Year by the People of the several States, and the Electors in each State shall have the Qualifications requisite for Electors of the most numerous Branch of the State Legislature.

No Person shall be a Representative who shall not have attained to the Age of twenty five Years, and been seven Years a Citizen of the United States, and when elected shall have been seven Years a Citizen of the State in which he shall be chosen.

Representatives and electors in each State shall have the Qualifications requisite for Electors of the most numerous Branch of the State Legislature.

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Constitutional Liens

Texas Constitution

“Mechanics, artisans, and materialmen, of every class, shall have a lien upon the **buildings and articles made or repaired** by them for the value of their labor done thereon, or materials furnished therefore; and the legislature shall provide by law for the speedy and efficient enforcement of said liens.”

Art. XVI § 37 of the Texas Constitution (emphasis added).

General Takeaways

Building or Articles

- Ex. Oil well casing is an article, not a building. *Ball v. Davis*, 118 Tex. 534, 544, 18 S.W.2d 1063, 1067 (1929)

Made or Repaired

- Ex. Oil well casing is not made. *Ball v. Davis*, 118 Tex. 534, 544, 18 S.W.2d 1063, 1067 (1929)
- Specially made?
- Routine Maintenance?

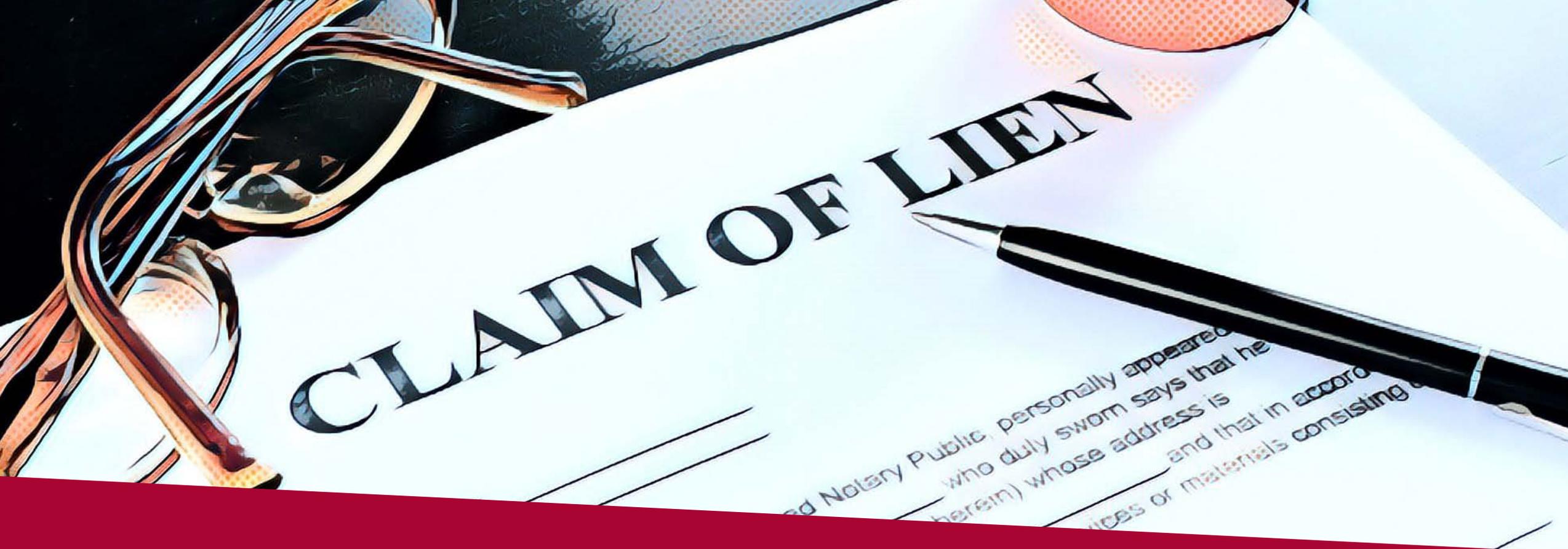
General Takeaways

Direct Privity of Contract with the Owner

- “[T]his provision does not give a lien to those who have no privity of contract with the owner.” *Gibson v. Bostick Roofing & Sheet Metal Co.*, 148 S.W.3d 482, 493 (Tex. App.—El Paso 2004, no pet.).

No affidavit required!

- “The lien authorized by this constitutional provision is **self-executing**, and exists independently and apart from any legislative act.” *Trinity Drywall v. Toka Gen. Contrs.*, 416 S.W.3d 201, 208 (Tex. App.—El Paso 2013, pet. denied)



Statutory Liens

Mechanic's Lien Act Basics

- Available for mechanic's, materialmen's laborers, engineers, landscapers.
- Improvement of real property
- Only available on private projects (public are covered by bonds).
- Complex rules and deadlines.

The Power of the Lien

- **Leverage** - It pressures the general contractor (and/or owner) to promptly pay. The owner needs the lien cleared to avoid issues with its lender or potential purchasers. The contractor needs the lien cleared to get paid by the owner.
- **Attorneys' Fees** - Court must award them to the extent “equitable and just.”
- **Bankruptcy Protection** - If the owner files for bankruptcy, then you still potentially have a secured claim in that bankruptcy. If a contractor files for bankruptcy, still potential for lien against the owner.

Statutory Liens During Bankruptcy



- Generally speaking you can file lien affidavit during a bankruptcy.
- Generally, two statutory liens that contractors should consider: Chapter 53 (Mechanic's Lien) and maybe Chapter 56 (Mineral Lien).
- You do it the same way plus you file a notice with the bankruptcy court.
- Before doing so, it is best to consult with bankruptcy counsel to ensure you do it in a way that does not violate the automatic stay imposed by the bankruptcy court.

Priority and Lien Inception: Why does it matter?



Determines when your lien is perfected and therefore where you stand in the order of secured claims

Contractors/Materialman

Inception and the Relation-Back Doctrine

- Lien is considered “perfected” when work first performed on project



Date of Inception: General Rule

Date of inception is the date of the **initial** commencement of **anyone's** construction under the original construction contract, rather than the date that the lien claimant commences its work or first delivers materials (i.e. it relates back to the date that the first subcontractor began work). *Oriental Hotel v. Griffiths*, 33 S.W. 652 (Tex. 1895)

Initial Construction Work – Initial construction work performed or materials delivered must be “visible” at the project site.

- **Commencement of work** – For work commenced, the Texas Supreme Court has held that this means the construction must: (1) be conducted on the land itself; (2) be visible on the land; and (3) be an activity that is an improvement under the mechanic's lien statute or excavation work.
- **Materials Delivered** – For materials delivered, the Texas Supreme Court has held that the goods must: (1) be delivered to the land; (2) be visible on the land; and (3) be consumed by, or incorporated into, the construction of the project.

Exception to General Inception Rule

Affidavit of Commencement – An owner and original contractor may jointly sign and record an “affidavit of commencement” within 30 days of actual commencement of construction or delivery of materials.

Content of Affidavit – The affidavit must contain:

1. The name and address of the owner;
2. The name and address of each original contractor, known at the time to the owner, that is furnishing labor, service, or materials for the construction of the improvements;
3. A description, legally sufficient for identification, of the property being improved
4. The date the work actually commenced; and
5. A general description of the improvement.

This affidavit is not dispositive of the issue, but it is “prima facie evidence of the date of the commencement of the improvement described in the affidavit.”

Exception to the General Inception Rule

No Continuing General Contract

- If no general contractor, each contractor's lien is determined by its own commencement and/or delivery of materials
- If general contract is terminated and new GC takes over, it does not relate back

Removables

- Mechanic's lien always has a preferential first priority over all other liens on removable improvements
- “Can be removed without material injury to the land or other improvements”

Architects/Engineers

- Lien is considered “perfected” when the lien affidavit is filed
- No relation-back doctrine!



Perfecting the Mechanic's Lien – Quick Refresher

Who Can File a Lien?

- Contractors
- Subcontractors
- Vendors / Suppliers
- Design Professionals



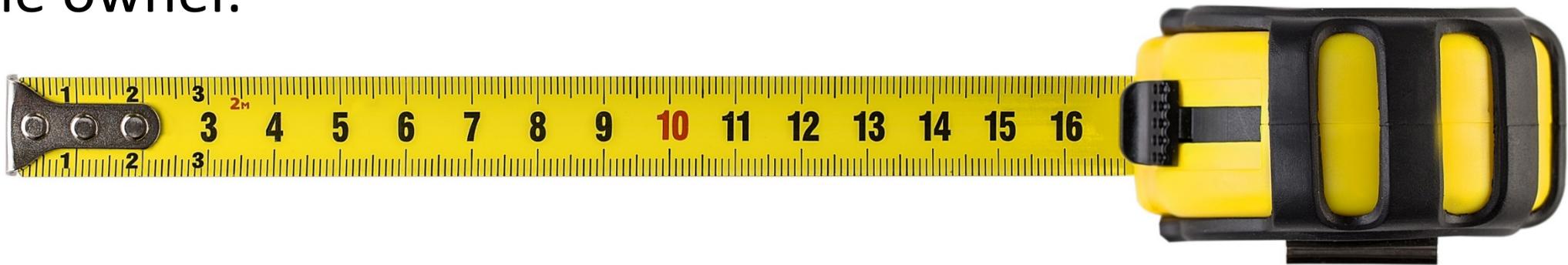
What Does Your Lien Cover?

- Real Property
- Retained Funds (statutory retainage)
- Possibly a Bond
- Chapter 53 does not cover oil/gas wells or pipelines.

Commercial Tenant Rebuilds

Generally, if your contract is with a tenant, the lien will only attach to the leasehold

Exception: If tenant acts as a general contractor or agent of the owner.



Mechanic's Lien Act Basics

Three Steps

- Pre-lien notice (traps funds)
- Lien affidavit
- Post-lien notice

Step 1: Funds Trapping/ Pre-Lien Notices

- Letter stating amounts due for work performed
- Authorizes owner to withhold and “trap” funds—creates liability on top of required 10% statutory retainage
- Sent via CMRRR
- None required if a general contractor

“2nd Month” Pre-Lien Notice

Second-Tier (and below) Subcontractor:

- Letter to general contractor stating amounts due
- 15th of the second month after work performed



The image shows a U.S. Postal Service Certified Mail Receipt form. The form is titled "U.S. Postal Service™ CERTIFIED MAIL® RECEIPT Domestic Mail Only". It includes a barcode on the left side and a "CERTIFIED MAIL" label. The form is divided into sections for "Certified Mail Fee", "Additional Services & Fees", "Postage", and "Total Postage and Fees". There are checkboxes for "Return Receipt (hardcopy)", "Certified Mail Restricted Delivery", and "Adult Signature Required". A "Postmark Here" area is also present. The form is marked with a large "SAMPLE" watermark.

“3rd Month” Pre-Lien Notice

First-Tier (and below) Subcontractor:

- Letter to general contractor **and** owner stating amounts due
- 15th of the third month after work performed



* PRO TIP: Include the owner on the second month notice so you don't have to send two notices!

Pre-Lien Notice

Labor or Materials Furnished and Unpaid In:	2 nd Month Notice	3 rd Month Notice
January	March 15 th	April 15 th
February	April 15 th	May 15 th
March	May 15 th	June 15 th
April	June 15 th	July 15 th
May	July 15 th	August 15 th
June	August 15 th	September 15 th
July	September 15 th	October 15 th
August	October 15 th	November 15 th
September	November 15 th	December 15 th
October	December 15 th	January 15 th
November	January 15 th	February 15 th
December	February 15 th	March 15 th

Step 2: Lien Affidavit

The Basic Logistics

- You must record it in the real property records for the county in which the property is located.
- Some counties allow e-filing.
- Others still require filing the original.
- There is a small fee.
- It will be a public record.
- It is under oath.
- Must be notarized.

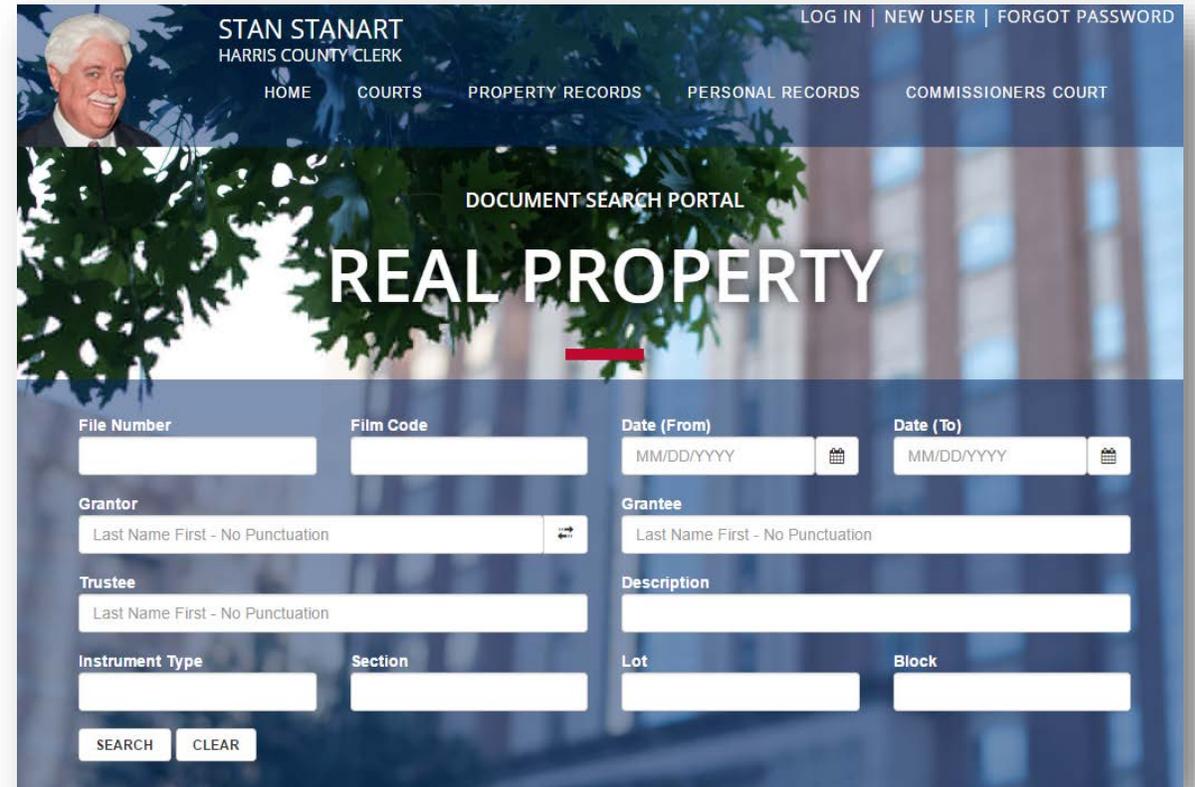
Lien Affidavit Contents

- Legal description
- Owner's name and address
- Months work performed
- Amount of claim
- Statement of type of work done
- Claimant's name, mailing and business address
- Sworn and Notarized

Property Description

Finding the Legal Description:

- Do not use CAD.
- Use the county's real property records – many are online for free.
- If unclear, then make statutory request for legal description from owner.



The screenshot shows the 'DOCUMENT SEARCH PORTAL' for 'REAL PROPERTY' on the Harris County Clerk's website. The header includes the name 'STAN STANART HARRIS COUNTY CLERK' and navigation links for 'HOME', 'COURTS', 'PROPERTY RECORDS', 'PERSONAL RECORDS', and 'COMMISSIONERS COURT'. The search form contains the following fields:

File Number	Film Code	Date (From)	Date (To)
<input type="text"/>	<input type="text"/>	<input type="text" value="MM/DD/YYYY"/>	<input type="text" value="MM/DD/YYYY"/>
Grantor	Grantee		
<input type="text" value="Last Name First - No Punctuation"/>	<input type="text" value="Last Name First - No Punctuation"/>		
Trustee	Description		
<input type="text" value="Last Name First - No Punctuation"/>	<input type="text"/>		
Instrument Type	Section	Lot	Block
<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>
SEARCH CLEAR			

Time to Record Lien Affidavit

- Record affidavit of mechanic's lien by the **15th day of the fourth** month in which the “indebtedness accrues”.
- “Indebtedness accrues” on . . .
 - General Contractor – “(1) the last day of the month in which a written declaration by the original contractor or the owner is received by the other party to the original contract stating that the original contract has been terminated, or (2) on the last day of the month in which the contract has been completed, finally settled, or abandoned.”
 - Subcontractor – **last day of the last month** in which the labor was performed or the material furnished.

Special Deadline for Statutory Retainage

File Affidavit Earliest of:

(1) 30 days after the work is completed, the original contract terminated or abandoned

Recording

- **Recording the Lien Affidavit**

- All statutory liens require filing of lien affidavit in the county where the property is located.



Step 3: The Post-Lien Notice

- Send affidavit via CMRRR to the owner within 5 days of recording.
- If a subcontractor, send to owner and original contractor.
- It is a good practice to include language threatening suit and attorneys' fees if no response/payment is received.



Mechanic's Lien - Enforcement

Lawsuit to foreclose lien must be filed by the later of:

- (1) two years of last day claimant could record its lien affidavit;
or
- (2) One year of completion/
termination/abandonment of
original contract.





Priority Issues

Owner Bankruptcy—Bank v. Lien Claimant

- Contractor performs work and/or supplies materials to Owner, and files Statutory Lien
- Bank lends money to Owner, and files UCC Security Interest
- Owner files bankruptcy
- Did the bank perfect its interest before inception of the project?

GC Bankruptcy—Bank v. Lien Claimant

Lien Claimant wins!

- Tex. Prop. Code § 53.121 – “PREFERENCE OVER OTHER CREDITORS. All subcontractors, laborers, and materialmen who have a mechanic's lien have preference over other creditors of the original contractor.”
- *In re Lone Oak Fabricators*, No. 08-42232, 2009 WL 1025092 (E.D. Tex. 2009) – Bankruptcy Court made clear that Section 53.121 is not limited to unsecured creditors; it also applies to secured creditors.
- Tex. Prop. Code § 53.151 – “A creditor of an original contractor may **not** collect, **enforce a security interest against**, garnish, or levy execution on the **money due the original contractor** or the contractor's surety from the owner, and a creditor of a subcontractor may not collect, enforce a security interest against, garnish, or levy execution on the money due the subcontractor, **to the prejudice of the subcontractors, mechanics, laborers, materialmen, or their sureties.**”

Highest Priority: Post-Petition Services

- Post-petition creditors have the highest priority amongst creditors



Mineral Liens

Mineral Liens Basics

The Basic Idea – A “mineral contractor” or subcontractor has a lien to secure payment for labor or services related to the mineral activities.”



Mineral Liens Basics

Unpacking the definitions:

- “Mineral contractor” - a person who performs labor or furnishes or hauls material, machinery, or supplies used in “mineral activities” under an agreement with a mineral property owner.
- Mineral subcontractor – means a person who has a contract with a mineral contractor.
- “Mineral activities - “digging, drilling, torpedoing, operating, completing, maintaining, or repairing an oil, gas, or water well, an oil or gas pipeline, or a mine or quarry.”
- "Mineral property owner" means an owner of land, an oil, gas, or other mineral leasehold, an oil or gas pipeline, or an oil or gas pipeline right-of-way.”

Property Mineral Lien Attaches to ...

- Goods furnished by claimant - “the material, machinery, and supplies furnished or hauled by the lien claimant.”
- The whole property/tract/lease – namely “land, leasehold, oil or gas well, water well, oil or gas pipeline and its right-of-way, and lease for oil and gas purposes” for which labor and goods were furnished or hauled and the buildings and appurtenances on this property.”
- Other material, machinery, and supplies used for mineral activities and owned by the owner.
- Other wells and pipelines on the property.



Attachment Continued

- “A lien created by performing labor or furnishing or hauling material, machinery, or supplies for a leaseholder does not attach to the fee title to the property.”
- In reality, you typically have a lien on the lease, not title to the actual land itself because usually the operator is the leaseholder and not the owner of the fee simple to the property.



Attachment Continued

Production and Production Proceeds

- The statute does not include either.
- The cases are mixed.
- One case held that a mineral lien does not encumber production or the proceeds from production. *Wilkins v. Fecht*, 356 S.W.2d 855 (Tex. Civ. App. San Antonio 1962, no writ).
- Another case allowed the appointment of a receiver to collect a lien claimant's share of production proceeds pending the foreclosure of the mineral lien. *Abella v. Knight Oil Tools*, 945 S.W.2d 847 (Tex. App.—Houston [1st Dist. 1997, no writ).



Perfection – Lien Notice

This applies only to mineral subcontractors, but it is a good practice to do it for mineral contractors too.

When? Not later than the 10th day before the day the affidavit is filed (six month deadline).

- It is usually a mistake to wait six months because section 56.043 provides the “owner is not liable to the subcontractor for more than the amount that the owner owes the original contractor when the notice is received.”

How? Certified mail return receipt requested. Use more than one address. (E.g. registered agent and/or headquarters)



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Perfection – Lien Notice Continued

Contents of the notice:

- The amount of the lien;
- The name of the person indebted to the subcontractor; and
- A description of the land, leasehold interest, pipeline, or pipeline right-of-way involved. The description should be a legal description. The best way to find it: use a landman or oil and gas title attorney to obtain the most recent lease.

Perfection – Lien Affidavit

Contents for mineral contractor:

1. The name of the mineral property owner involved, if known;
2. The name and mailing address of the claimant;
3. The dates of performance or furnishing;
4. A description of the land, leasehold interest, pipeline, or pipeline right-of-way involved; and
5. An itemized list of amounts claimed.

Contents for mineral subcontractor:

Same as above plus:

6. The name of the person for whom labor was performed or material was furnished or hauled
7. A statement that the subcontractor timely served written notice that the lien is claimed on the property owner or the owner's agent, representative, or receiver.

Perfection – Lien Affidavit Continued

Where to file? County clerk for county in which property is located.

When? Six months or less after “the day the indebtedness accrues”.

- “The indebtedness for material or services accrues on the date the material or services were last furnished.”
- All material or services that a person furnishes for the same land, leasehold interest, oil or gas pipeline, or oil or gas pipeline right-of-way are considered to be furnished under a single contract unless more than six months elapse between the dates the material or services are furnished.”
- Remember the ten day notice requirement.
- Do not wait six months, the owner has a defense if payment is already made.

Enforcement

- A claimant must enforce the lien within the same time and in the same manner as a mechanic's, contractor's, or materialman's lien under Chapter 53.
- Same rules regarding statute of limitations, attorneys' fees and other provisions related to enforcement.
- This is limited to enforcement not perfection.

What is my priority?

Texas Property Code Sec. 56.004

(a) The lien does not affect an encumbrance that attached to land or a leasehold before the lien's inception.

(b) The lien on material, machinery, supplies, or a specific improvement takes priority over an earlier encumbrance on the land or leasehold on which the material, machinery, supplies, or improvement is placed or located.

Takeaways

- Make sure your lien is properly perfected – i.e. timely filed and substantively complies with statutory lien statute

- Make sure you trap funds



Unsecured Claims

Types of Claims

Common Construction Claims

- M&M Constitutional Lien – secured.
- M&M Statutory Lien – secured.
- Mineral Statutory Lien – secured.
- Contract claim – unsecured.
- Trust fund claim – unsecured.

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Contract Claims

- These are unsecured claims because they are just a claim against the debtor for money.
- Good terms to have: attorneys' fees and interest. Most importantly, personal guaranty.

Contract Claims

When the work was performed matters.

- Pre-petition goods and services – Lowest priority.
- Post-petition goods and services – Possible administrative claim. High priority.
- Administrative expenses, include "the actual, ***necessary*** costs and expenses of preserving the estate..." 11 U.S.C. §503(b)(1)(A) (emphasis added)

Texas Trust Fund Act- Basics

- Benefits those furnishing labor or materials for the construction or repair of a house, building, or improvement by creating a statutory trust that protects all parties in the construction chain
- Recognizes that general contractors routinely deposit project monies into a few common accounts; subcontractors and suppliers are subsequently paid from these accounts without having to first plead entitlements to those funds
- Provides for civil and criminal penalties to those who misappropriate trust funds and fail to pay for labor and materials

Texas Trust Fund Act – The Beneficiaries

- Sec. 162.003. BENEFICIARIES OF TRUST FUNDS. (a) An artisan, laborer, mechanic, contractor, subcontractor, or materialman who labors or who furnishes labor or material for the construction or repair of an improvement on specific real property in this state is a beneficiary of any trust funds paid or received in connection with the improvement.
- Contractors and subcontractors are beneficiaries.
- Design Professionals are probably not.

Texas Trust Fund Act – Trustee Defined

- Sec. 162.002. “A contractor, subcontractor, or owner or an officer, director, or agent of a contractor, subcontractor, or owner, who receives trust funds or who has control or direction of trust funds, is a trustee of the trust funds.”
- Personal Liability
- No contractual privity required

Interesting Case – *In re Waterpoint Int.* (5th Cir.)

- The sub in *Waterford* tried to argue that it had an automatic secured claim under Section 53.151 of the Texas Property Code even though it failed to perfect its lien claim.
- Tex. Prop. Code Section 53.151 “A creditor of an original contractor may not collect, enforce a security interest against, garnish, or levy execution on the money due the original contractor or the contractor's surety from the owner, and a creditor of a subcontractor may not collect, enforce a security interest against, garnish, or levy execution on the money due the subcontractor, to the prejudice of the subcontractors, mechanics, laborers, materialmen, or their sureties.”
- Sub used this provision even though they did not perfect a lien to have a secured claim. To fill the gap, the sub attempted to argue that the trust fund statute applied to the funds and worked together with this provision to give them a superior right to the funds.
- Although creative, the 5th Circuit rejected that argument and made it clear that Section 53.151 does not apply to subs who do not perfect liens.

Texas Trust Fund Act – Defenses

- Funds used on “actual expenses directly related to the project”
- Funds “retained by the trustee, after notice to the beneficiary who has made a request for payment, as a result of the trustee’s reasonable belief that the beneficiary is not entitled to such funds or retained as authorized by Chapter 53”
- Funds paid beneficiaries no later than 30 days following written notice of complaint or criminal investigation

Interplay between Trust Fund Act and Bankruptcy

- ***Scenario 1*** – Dischargeability
- ***Scenario 2*** – Claims to funds held by bankruptcy estate
- ***Scenario 3*** – Defenses to Preference Claims (more on this later).

Scenario No. 1

- Subcontractor performs work for General Contractor on a Commercial Construction Project.
- General Contractor is paid by Owner (i.e. Trust Funds).
- General Contractor misuses the Trust Funds.
- General Contractor declares bankruptcy.
- What are the subcontractors options? File adversary proceeding against General Contractor for violation of Chapter 162 of the Texas Property Code. Judgment against General Contractor is non-dischargeable.

Dischargeability

- **General Rule** – Debts are discharged in bankruptcy
- **Exception** – “for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.” See 11 U.S.C. § 523(a)(4).
- *In re Nicholas*, 956 F.2d 110 (5th Cir. 1992) – Fiduciary obligation created if debtor retained, used, disbursed or diverted funds “with intent to defraud.”
- Creditor has this burden of proof
- This is a higher standard than required to prove up a civil trust fund case:
“A trustee who, *intentionally or knowingly* or with intent to defraud, directly or indirectly retains, uses, disburses, or otherwise diverts trust funds without first fully paying all current or past due obligations incurred by the trustee to the beneficiaries of the trust funds, has misapplied the trust funds.”

Scenario No. 2

- Subcontractor performs work for General Contractor on a Commercial Construction Project.
- General Contractor is paid by Owner for work performed (i.e. Trust Funds) and deposits funds in trust account with the intent to pay Subcontractor for work performed.
- General Contractor files for bankruptcy prior to disbursing funds to Subcontractor.
- Can the Subcontractor petition the Bankruptcy Trustee to disburse the Trust Funds from the Estate? Arguably.

Petitioning the Trustee for Trust Funds in the Possession of the Estate

- Debtor is only entitled to retain “Property of the Estate.”
- “Property of the Estate” – “Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest.” 11 U.S.C. § 541(d).
- Statutory trust funds are not part of the estate because the Debtor holds no equitable interest in said funds. *U.S. v. Ron Pair Enter., Inc.*, 489 U.S. 235 (1989).
- Procedure: Motion to Lift Stay, Motion to Authorize Debtor to Pay Trust Funds, or to file an Adversary Claim.

In re Contractors' Holding, 343 B.R. 573 (S.D. Tex. Bankr. 2006)

- **Factual Background** – Contractor files for bankruptcy. After petition filed, Contractor pays various subcontractors for work performed. Trustee makes a timely demand, alleging that the checks constituted an avoidable transfer under 11 U.S.C. § 549. Trustee subsequently commenced an adversary proceeding.
- **Holding** –
 - (1) Post-petition transfer governed by Section 549 of the Bankruptcy Code. Section 549 – “The Trustee may avoid a transfer of **property of the estate** that occurs after the commencement of the case . . .”
 - (2) Section 541(a)(1) defines “property of the estate” as “all legal or equitable interests of the debtor in property at the commencement of the case.”
 - (3) Post-petition trust funds are property of the estate because debtor retains legal title to trust funds.
 - (4) Therefore, a trustee can seek to avoid the post-petition transfer of said trust funds.
- **Takeaway** – Kind of inconsistent results (i.e. pre-petition transfer of trust funds generally cannot be clawed back, but post-petition transfer of trust funds can be clawed back). The reason being – the difference between how Section 547 and 549.

The Legislature Amends Chapter 162

H.B. 1513 passed in 2009:

162.001(d) – “Trust funds paid to a creditor under this chapter are not property or an interest in property of a debtor who is a trustee described by Section 162.002.”

162.031(d) – “A trustee who commingles trust funds with other funds in the trustee's possession does not defeat a trust created by this chapter.”

Legislative Intent

The Texas House Committee Report from the Business and Industry Committee describes the purpose of House Bill 1513 as follows:

“HB 1513 revises the Texas Construction Trust Fund Act to deal with the effects of the preferential transfer statute and to clarify remedies intended to be provided by the act. Specifically, the bill states that trust funds in the hands of a construction trustee are expressly removed from the debtor's bankruptcy estate, states that the commingling of funds by a construction trustee with other funds of the construction trustee does not destroy the trust nature of the funds, and clarifies that the act applies to both public and private projects in Texas whether bonded or not.” *In re RTX Custom Homes, Inc.*, 2017 WL 2484850,*37 (W.D. Tex. Bankr. 2017).

Scenario No. 3

- Subcontractor performs work for General Contractor on a Commercial Construction Project.
- General Contractor is paid by Owner for work performed (i.e. Trust Funds).
- General Contractor files for bankruptcy.
- The General Contractor disburses the Trust Funds to the Subcontractor *prior to (but within 90 days of)* filing for bankruptcy.
- Can the Bankruptcy Trustee successfully argue that this was a preferential transfer and seek to claw back the trust funds paid to the Subcontractor? **Probably not.**



Bankruptcy Preferences

Definition of a Preferential Transfer, i.e., “Preferences”

- Any transfer of an interest (e.g., payment) of the debtor:
 - For the benefit of a creditor.
 - On account of an antecedent debt owed by the debtor.
 - Made while the debtor was insolvent.
 - Made (1) in the 90 days prior to filing bankruptcy or (2) up to one year prior to filing bankruptcy if the transfer was made to an insider.
 - That enables the creditor to receive more than such creditor would receive if the case was a chapter 7 liquidation.

Definition of a Preferential Transfer, i.e., “Preferences”

- Preferences are not limited to monetary transfers – the granting of a lien can also potentially be a preference.
- Debtor is presumed insolvent during 90 day period.
- No intent required.
- “Aggregate” must be at least \$6,825.



The Purpose vs. the Reality

- Purpose – Fair distribution to Creditors.
- What happens in reality?
 - This is commonly high volume litigation.
 - Demand letters are often sent out based solely on Debtor's schedules.
 - There is often very little investigation into the merits of the claim prior to suit being filed.
 - For creditors, these are often unanticipated.
 - They can create be devastating financially.

Defenses – Subjective Ordinary Course

There are many affirmative defenses – the creditor has the burden of proof:

Ordinary course of business in terms of creditor/debtor relationship:

- **What it means?**
 - Ordinary as it relates to the creditor/debtor's history.
 - Subjective.
- **How do you prove it?**
 - Historical data 1-2 years prior to preference period.
 - Average days elapsed between invoice dates and payment dates.
 - Negative factors: unusually quick or late payments, demand letters, and other collection activity.



Defenses – Objective Ordinary Course

Ordinary course of business in terms of industry standard:

- **What it means?** Ordinary in terms of other businesses in the creditor's industry.
- **How do you prove it?**
 - Hire an expert.
 - The expert will then compare the preference payment data with industry data to determine whether there are material deviations.



Defenses – Subsequent New Value

Basic Idea in the construction context

After receipt of the preferential transfer, the creditor advances additional credit to the debtor that:

- Is unsecured; and
 - Remains unpaid as of the time of the bankruptcy filing (i.e., is not a preference).
-
- This defense is often basic math and easily established by a spreadsheet.



Construction Related Defenses

Joint Checks

- A joint check issued by a general contractor to a subcontractor and its subcontractor can be a preference.
- Best Practice – Get a Joint Check Agreement that states insolvent party has no right to the funds other than to pay the particular creditor. Use the joint check agreement to label the funds as trust funds under Chapter 162.



Construction Related Defenses

- **Lien rights** - Waiving the right to file liens in exchange for payment provides value to the debtor. This gives rise to a potential defense based on the exchange of value for the payment.
- **Trust Fund Act** - If the debtor made the payment with construction trust funds under Chapter 162 and the creditor/defendant was a beneficiary of such funds, then the funds belonged to the creditor/defendant, not the debtor. *See* 11 U.S.C. Section 547.



Trustee Clawing Back Transfer of Trust Funds

- Section 547 allows the bankruptcy trustee to seek to avoid “any transfer of an interest of the debtor in property,” made in the form of money or other property, to or for the benefit of a creditor of a pre-existing debt, while a debtor was insolvent, if and only if that transfer allowed a creditor to receive more than it would receive under chapter 7 of the Bankruptcy Code. 11 U.S.C. § 547(b).
- *Begier v. IRS*, 496 U.S. 53 (1990) – The purpose of Section 547 is to return the estate “property available for distribution to creditors.”



Trustee Clawing Back Transfer of Trust Funds Cont.

- *In the Matter of Maple Mortgage, Inc.*, 81 F.3d 592 (5th Cir. 1996) – “If funds cannot be used to pay the debtor’s creditors, then they generally are not deemed an asset of the debtor’s estate for preference purposes. A common example is when a debtor holds funds in trust for another.”
- Because a debtor holding trust funds has no beneficial or equitable interest in them, a bankruptcy court would likely deny a trustee’s attempt to avoid a pre-petition transfer of trust funds.



Forum

If you have not filed a proof of claim or otherwise submitted yourself to the jurisdiction of the bankruptcy court, you may be able to “withdraw the reference.”

- District Court
- Jury trial
- Pretrial in bankruptcy court



Questions ?



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- Opened in 1985

Thank you!



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