

"DON'T LIEN ON ME"
CONSTRUCTION LAW ISSUES IN
BANKRUPTCY

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CHAPTER 10

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I. INTRODUCTION

The advent of a new economic environment after ten years of sustained growth will certainly impact specific segments of the economy. One area of phenomenal growth over the past decade was real estate construction, both commercial and residential. Unfortunately, the construction arena may be particularly hard hit by the "new economy" due to a number of factors, including reduced capital expenditure by businesses, the stock market's rapid decline and its impact on the so called "wealth effect" and the historic tendency of owners and developers toward overbuilding in the real estate sector. Coupled with these factors are more traditional problems that can exacerbate the likelihood of financial distress: negligence or mismanagement, fraud, lender or creditor pressures, price increases, etc. When these factors combine together, the end result is typically a bankruptcy filing.

Construction law issues are often complicated and perplexing. The statutory scheme in Texas and most other states to protect subcontractors and materialmen and the resulting case law are such that strict compliance is essential but may be the difference between prompt payment and non-payment. Construction law problems, from disputed change orders to improper installation, are usually factually intensive. When these characteristic problems are introduced into a bankruptcy scenario, the number of competing and often conflicting interests can be overwhelming. An understanding of how these two, sometimes conflicting, statutory frameworks interrelate, can often spell the difference between disaster and success.

This Article will not attempt to address the myriad issues that may arise within the context of real estate bankruptcies, in general, or construction bankruptcies, in particular, but rather, it will highlight some of the more common issues a bankruptcy practitioner might expect to encounter and attempt to address some of the more common pitfalls when advising a client faced with construction law issues in bankruptcy. Since Texas bankruptcy practitioners will likely

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encounter local construction bankruptcies, particular emphasis is placed on the relevant Texas statutes. However, each state will have its own statutes and unique case law, which is beyond the scope of this Article.

Depending on who you represent in a construction bankruptcy case will dictate your objectives, strategy and tactics. The following are just a few issues that you will want to be aware of in order to either maximize the recovery or minimize the exposure of your client:

- Who has the money and where is it?
- How do you get the money to satisfy your claim?
- If you get paid, will you later be subject to a claim seeking recovery of the payment?
- If you owe money, will you have multiple exposure if you pay it to the contractor or third parties?
- How do you protect yourself from exposure if you owe money?
- If money is owed, how do you avoid liens from being filed on your property?

These issues often arise in construction controversies and the answer to the questions may depend on which law is applicable and what strategy is employed in achieving your objectives.

II. MECHANIC'S LIENS—AN OVERVIEW¹

The starting point in analyzing a construction bankruptcy is to understand the nature and scope of the unique protections offered to mechanics and materialmen. In an effort to protect suppliers of materials, subcontractors, and contractors, the Texas Legislature has created a system of involuntary liens through both the State's Constitution and the Texas Property Code ("Property Code"). Contractors and suppliers that

¹ The authors express their sincere thanks to Gregory A. Harwell, Gardere & Wynne, L.L.P. and Lorman Education Services for the use of portions of this Section of this Article.

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carefully monitor the payments of invoices and progress of construction can secure their right to full payment, provided they strictly comply with the requirements of the Property Code. Similarly, owners, project managers, and lenders supervising construction should monitor the progress and know their obligations to satisfy the claims of those persons claiming liens. Invariably, when a construction bankruptcy occurs, one of the more troublesome issues will be whether mechanics' and materialmen's liens can or will be asserted and if they already have been, whether they are proper and if so, what priority do they hold.

In general, the Texas Constitutional lien is designed to protect the contractor in his dealings with an owner and is limited in many situations. The Texas Property Code lien offers greater protections, but requires claimants to perform two critical steps to create their liens: send notice letters and file lien affidavits. These documents are the usual prerequisites to perfecting a lien and the right to payment. Obviously, situations are often clouded with claims of faulty workmanship or partial completion, not to mention extra work, "change orders," and other problems. However, creating and defeating mechanics' liens is often the most important issue arising in large construction projects and related construction bankruptcies.

III. CONSTITUTIONAL LIENS

For *original contractors*, the Texas Constitution provides a self-executing lien for improvements to property.² It protects persons that make or repair "buildings and articles," and the original contractor need not comply with the requirements of Chapter 53 of the Property Code to enforce this lien. A subcontractor, on the other hand, has no constitutional lien and must comply with Chapter 53.³

One typically considered a subcontractor may qualify as an original contractor if it can show: (1) that the owner ordered work or materials directly from it; or (2) that there is a *sham contract* between the owner and the original contractor.⁴ The sham contract relationship is usually found in captive contractor situations, where a large real estate company has a contractor that works only on its property. However, one court has held that a sham contract relationship does not allow the (sub)contractor to sue the original owner on the contract, rather, it simply provides that the (sub)contractor need not comply with all of the notice requirements for creation of a lien.⁵

A constitutional lien is only valid for *articles* or *buildings* and the land necessary to its enjoyment. Suppliers of materials such as refrigerators which are not *incorporated* into the project may not acquire a constitutional lien, even if ordered directly by the owner. This does not mean that suppliers of off-the-shelf items cannot get protection. The suppliers must still have a contract with the owner and supply items to be incorporated into a specific building or article.

Although a constitutional lien exists without the necessity of a lien affidavit, circumstances which would bar collection of the debt can prevent enforcement of the lien, and a constitutional lien cannot be enforced against a good faith purchaser without knowledge of the lien claim.⁶ Therefore, since the filing of a lien affidavit is relatively simple and will put all potential purchasers on notice of the lien, it is

² { TA \c 3 \s "Tx. Const. XVI, § 37" \l "TEX. CONST. art. XVI, § 37"}TEX. CONST. art. XVI, § 37.

³ The lien does not apply to property owned by the United States Government or by the State of Texas. The lien will apply to a homestead, but the statutory requirements for homesteads must be followed. See TEX. CONST. ART. XVI, § 50 AND TEX. PROP. CODE §§ 41.001, ET SEQ. AND 53.254.

⁴ See § 53.026 (effective control between owner and sham contractor through ownership of voting stock, interlocking directorships, or otherwise; or original contract made without good faith intention that other party was to perform the contract).

⁵ { TA \c 1 \s "SW Prop. v. Lite-Dec" \l "Southwestern Properties, LP v. Lite-Dec of Texas, Inc., 989 S.W.2d 69 (Tex. App. San Antonio 1999)"}Southwestern Properties, LP v. Lite-Dec of Texas, Inc., 989 S.W.2d 69 (Tex. App. San Antonio 1999).

⁶ See, e.g., *Contract Sales Co. v. Skaggs*, 612 S.W.2d 652 (Tex. Civ. App. – Dallas [5th Dist.] 1981).

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strongly recommended that a lien affidavit be filed in appropriate circumstances.⁷

⁷

Although the Constitution does not establish any deadlines in order to file a constitutional lien, one court has ruled that it must be filed by the 15th of the month, four months after the work is completed. *The Detering Co. v. Green*, 989 S.W.2d 479 (Tex. App.--Houston [1st Dist.] 1999).

IV. STATUTORY LIENS ON REAL ESTATE AND BONDS

A. PERSONS COVERED

The Property Code describes three general categories of persons who may be entitled to a lien: (1) suppliers of labor or material; (2) persons specially fabricating materials; and (3) certain design professionals.

1. Suppliers of Labor or Materials

Persons who supply labor or materials for construction or repair of houses, buildings, improvements, levees and embankments along a river or creek, or railroads, by virtue of a contract with an owner, trustee, receiver, contractor or subcontractor, are generally entitled to a lien.⁸ The labor or material must be used in the direct prosecution of the work.⁹ Although not specifically required by the Property Code, it appears that a contractor must substantially complete the contract to be entitled to a statutory lien, at least in those circumstances where the owner is not in default.

2. Specially Fabricated Materials

To justify the imposition of a lien, a supplier's goods must be used in or delivered to the project. However, the Property Code provides an exception to this general rule that materials must be delivered to, incorporated into, or consumed in the work for certain goods. Persons who specially fabricate materials which are *reasonably unsuitable* for use elsewhere are entitled to a lien,¹⁰ even if the material is not delivered to or incorporated into the work.¹¹

3. Design Professionals

Design professionals cannot utilize the protections of the Texas Constitution to secure

payment, and until several years ago, they were not a "person entitled to a lien". Now, architects, engineers or surveyors who prepare a plan or plat in connection with the actual or proposed design, construction or repair of improvements or who prepare a survey of property lines are entitled to a statutory lien on the real property to secure payment for their work.¹²

The architect, engineer, or surveyor must file an affidavit claiming a lien by the 15th day of the month, four months after it ceases work. One difference between it and the mechanics' liens, is that the lien created under section 53.021(c) takes effect on the date the lien affidavit is filed. If property is sold or pledged to secure a loan before a lien affidavit is filed, the professional cannot enforce the lien against the property.

B. WORK COVERED

1. Labor and Material--Generally

A properly perfected lien secures payment for labor or material furnished for construction or repair, and for specially fabricated material regardless of delivery or incorporation into the construction or repair, less its fair salvage value.¹³ Labor must be supplied in the *direct prosecution* of any construction or repair of an improvement to form the basis of a statutory lien.¹⁴ While clearing, grubbing or draining of land constitutes an *improvement* subject to a lien, removal or demolition of an existing structure is *not* work which may be covered by a mechanic's lien¹⁵ and materials supplied for demolition work may equally not serve as the basis for a lien.¹⁶

⁸ { TA \c 3 \s "TPC 53.021(a)" \l "TEX. PROP. CODE § 53.021(a)"}§ 53.021(a).

⁹ { TA \c 3 \s "TPC 53.001(3)" \l "TEX. PROP. CODE § 53.001(3)"}§ 53.001(3), { TA \c 3 \s "TPC 53.001(4)" \l "TEX. PROP. CODE § 53.001(4)"}(4).

¹⁰ { TA \s "TPC 53.021(a)"}§ 53.021(a).

¹¹ { TA \c 3 \s "TPC 53.021(b)" \l "TEX. PROP. CODE § 53.021(b)"}§ 53.021(b), { TA \c 3 \s "TPC 53.023" \l "TEX. PROP. CODE § 53.023"}§ 53.023.

¹² { TA \s "TPC 53.021(c)"}§ 53.021(c).

¹³ { TA \s "TPC 53.023"}§ 53.023.

¹⁴ §§ 53.001(3) and 53.021(a).

¹⁵ { TA \c 1 \s "Big Three v. Crutcher" \l "Big Three Welding Equipment Co. v. Crutcher, Rolfs, Cummings, Inc., 229 S.W.2d 600 (Tex. 1950)"}*Big Three Welding Equipment Co. v. Crutcher, Rolfs, Cummings, Inc.*, 229 S.W.2d 600 (Tex. 1950).

¹⁶ { TA \c 1 \s "J & J v. Pilkinton" \l "J & J Equipment, Inc. v. Pilkinton, 850 S.W.2d 804 (Tex. App.--Corpus Christi 1993, writ denied)."}*J & J Equipment, Inc. v. Pilkinton*, 850 S.W.2d 804 (Tex. App.--Corpus Christi 1993, writ denied).

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However, this rule does not apply if the work can be considered as *clearing* of land.

The scope of materials which are covered by a properly perfected lien includes: (1) material, machinery, fixtures or tools incorporated into the work, consumed in the direct prosecution of the work, or ordered and delivered for incorporation or consumption; (2) rent at a reasonable rate and actual running repairs at a reasonable cost for construction equipment used or reasonably required and delivered for use in the direct prosecution of the work at the site of construction and repair; and (3) power, water, fuel, and lubricants consumed or ordered and delivered for consumption in the direct prosecution of the work.¹⁷

A chattel which is permanently affixed (*i.e.*, incorporated in) or intended to be permanently affixed to the improvement will be covered by a properly perfected statutory lien. As an example, appliances which are built into or otherwise affixed to the improvement may be subject to a lien, while these same appliances would not support a statutory lien if they were merely plugged into the wall socket.¹⁸

2. Material--Specially Fabricated Material

Specially fabricated material is merely "material" which is fabricated for use as a component of the construction or repair so as to be *reasonably unsuitable* for use elsewhere.¹⁹ While specially fabricated material need never be

¹⁷ { TA \s "TPC 53.001(4)"}§ 53.001(4). Material which is *intended* to be "incorporated in or consumed in the construction or repair" will support a lien. It is the ultimate intended use of the material, as opposed to its actual use, which determines whether a statutory lien may be imposed. Therefore, a lien cannot be defeated by showing that the buyer elected not to use the materials which were originally sold and delivered for incorporation into the work.

¹⁸ One advancing money to a subcontractor or supplier is not entitled to a mechanic's lien, even if the money is used to pay for labor or material. However, the person that pays on checks drawn to the subcontractor may be able to enforce the lien rights of the subcontractor.

¹⁹ § 53.001(9).

delivered to or incorporated in the job in order for a lien to attach, the analysis of whether a lien may be perfected is the same as for other material subject to the fair salvage rule.²⁰

3. Labor--Design and Supervision

An architect, engineer or surveyor may have a statutory lien under two scenarios. First, where the designer merely prepares plans or plats *and* satisfies the preliminary requirements of section 53.021(c), the designer may have a lien for the design work. Second, where the designer prepares plans *and* supervises construction of improvements without meeting the statutory prerequisites, the designer may have a lien for the supervision. Unless the requirements of section 53.021(c) are met, or the designer performs supervisory work, the design professional is not entitled to a lien for professional services.

C. PROPERTY SUBJECT TO LIEN

Section 53.022 provides the statutory description of property which is subject to a properly perfected lien: the house, building, fixtures or improvements, the land reclaimed from overflow, or the railroad and all of its properties, and to each lot of land *necessarily connected* or reclaimed. A lien in town extends to each lot on which the house, building or improvement is situated; while a lien in the country is limited to 50 acres. However, a statutory lien cannot be asserted against public property.

The term "lot" has been construed as the entire undivided tract of land as recorded in the deed records, and not merely to the improvement and the surrounding land. Therefore, a lien on the entire tract will survive, even if a portion of it is sold after the work is started.²¹

When materials are supplied under a single contract for improvement of multiple lots, the lien attaches to *all* lots, so long as the lots are

²⁰ § 53.023.

²¹ { TA \c 1 \s "Valdez v. Diamond Shamrock" \l "Valdez v. Diamond Shamrock Refining & Mktg. Co., 842 S.W.2d 273 (Tex. 1992)"}Valdez v. Diamond Shamrock Refining & Mktg. Co., 842 S.W.2d 273 (Tex. 1992).

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contiguous. The question of "contiguous" or "necessarily connected" lots is not an easy one to answer. The Fifth Circuit, in applying Texas law, held that a contractor who had performed work on a hotel's parking garage at the same time the hotel was being constructed was only entitled to a lien on the garage.²² Similarly, a Houston court of appeals held that one who performed work on a warehouse across the street from, but which was part of, a complex of offices being constructed could only assert a lien against the warehouse itself.²³

Once a lien is perfected, it extends to all improvements, even those made by others. It does not, however, attach to "fixtures."²⁴ Whether an item is a "fixture" is not easily answered. A fixture is determined by the following factors for consideration:

The manner and extent of attachment to the land or existing improvements; the extent to which removal would necessitate repairs, modification and/or protection of the land or existing improvements; the state of completion of improvements under construction at the time removal is sought; and the function of the improvements sought to be removed.

D. NOTICE REQUIREMENTS

²² { TA \c 1 \s "H.B. Zachary Co. v. Waller" \l "H.B. Zachary Co. v. Waller Creek, Ltd. (In re Waller Creek, Ltd.), 867 F.2d 228 (5th Cir. 1989)" }H.B. Zachary Co. v. Waller Creek, Ltd. (In re Waller Creek, Ltd.), 867 F.2d 228 (5th Cir. 1989).

²³ { TA \c 1 \s "Houston Elec. Dist. v. MMB" \l "Houston Electrical Distributing Co., Inc. v. MMB Enterprises, 703 S.W.2d 206 (Tex. App. Houston [14th Dist.] 1985)" }Houston Electrical Distributing Co., Inc. v. MMB Enterprises, 703 S.W.2d 206 (Tex. App.--Houston [14th Dist.] 1985).

²⁴ { TA \c 1 \s "FNB Dallas v. Whirlpool" \l "First National Bank in Dallas v. Whirlpool Corp., 517 S.W.2d 262 (Tex. 1974)" }First National Bank in Dallas v. Whirlpool Corp., 517 S.W.2d 262 (Tex. 1974).

There are only two methods to perfect a mechanic's lien on property, to trap funds in the hands of the owner or to make a claim against the owner's held retainage. Both of these methods require the sending of written notice.

Serving proper and timely notices as required under the Texas Property Code serves two primary functions. First, it is a necessary prerequisite to satisfy the conditions precedent to perfect a statutory lien.²⁵ The notice can either "trap" funds in the owner's possession or provide the basis to share in the owner-withheld retainage. Second, notice serves the business purpose of notifying an owner, a lender and others of potential problems.

1. Notice Fund Trapping

In order to authorize an owner to withhold funds due and owing the general contractor, a derivative claimant must provide written notice to the owner by registered or certified mail that if the claim remains unpaid, the owner may be "personally liable and the owner's property may be subjected to a lien unless: (1) the owner withholds payments from the contractor for payment of the claim; or (2) the claim is otherwise paid or settled."²⁶ Unless the funds are properly "trapped," the subcontractor's recovery could be limited to its share of the 10% retainage required of the owner.

Once the owner receives a "trapping" letter, it must withhold sufficient funds until: (1) the claim is settled, discharged or indemnified; (2) the time for filing the affidavit claiming a mechanic's lien has passed; or (3) the lien claim has been satisfied or released.²⁷ The claimant

²⁵ § 53.051.

²⁶ § 53.056(d). While the statutes state that a copy of the claimant's statement or billing in the usual and customary form is sufficient to satisfy this notice requirement, the claimant should always include the statutory language described above. *See, Brown v. Dorsett Bros. Concrete Supply, Inc., 705 S.W.2d 765 (Tex. App.--Houston [14th Dist.] 1986, no writ)* (failure to include statutory language would avoid "trapping" of funds).

²⁷ { TA \c 3 \s "TPC 53.082" \l "TEX. PROP. CODE § 53.082" }§ 53.082.

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may initiate the payment process by making a written demand for payment.²⁸ The claim cannot be made after the time within which the claimant may secure a lien for the claim.²⁹ The demand must give notice to the owner that all or part of the claim has accrued under section 53.053 or is past due.³⁰ A copy of the demand must be sent to the original contractor, which then has 30 days to notify the owner if the claim is disputed. If the original contractor fails to do so, it is deemed to have assented to the claim and the owner *shall* make payment to the claimant.³¹

Even in the event that the claimant has failed to properly trap funds or satisfy the conditions precedent to perfection of a claim against the property or the retained funds, it should investigate the possibility of asserting a claim under the trust fund doctrine.³²

2. Earlier Notice For Suppliers

In addition to the general notice that all claimants must submit to the general contractor and owner, lower tier claimants must send another notice. If a claimant does not have a contract with the general contractor, it must notify the general contractor that it has a contract with a subcontractor and that it has supplied labor or materials and has not been paid. This notice must be sent by the 15th day of the *second* month after supplying labor or materials that have not been paid. This is commonly referred to as the "second month" notice.

Accordingly, a supplier to a subcontractor must initially notify the general contractor that it has supplied material and has not been paid. Then, if still unpaid, the supplier must notify the owner and general contractor that it has not been

paid and the owner should set aside money to insure that it is paid.

3. Notice By Lien Affidavits

The final step in perfecting a mechanic's lien is filing an affidavit claiming a lien. The specific requirements for the affidavit are mentioned below. The affidavit is filed in the real property records and is forwarded to the owner and the general contractor. This provides further written notice of the debt and the claim of lien.

4. Perfection of Contractual Retainage Claim

If a derivative claimant supplies work or labor under an agreement which provides for a retainage and wishes to perfect a lien for that retained amount, the claimant must act at the inception of the work. The supplier must notify the owner or reputed owner of the retainage agreement by registered or certified mail at the last known business or residence address not later than the *15th day of the second month* following the delivery of materials or performance of labor by the claimant that *first occurs* after the claimant has agreed to the contractual retainage.³³ The notice must contain: (1) the sum to be retained; (2) the due date or dates, if known; and (3) a general indication of the nature of the agreement. If the claimant's agreement is with a subcontractor, that same notice must be given to the original contractor within the same time period.³⁴

If the claimant gives this notice and satisfies the notice requirements of section 53.055, no further notice is required to perfect a lien on retainage.³⁵

5. Perfection of Statutory Retainage Claim

The Property Code requires owners to hold 10% as retainage during the work and for 30 days after completion of the work.³⁶ The retained

²⁸ § 53.083.

²⁹ { TA \c 3 \s "TPC 53.083(d)" \l "TEX. PROP. CODE § 53.083(d)"}§ 53.083(d).

³⁰ { TA \c 3 \s "TPC 53.083(a)" \l "TEX. PROP. CODE § 53.083(a)"}§ 53.083(a).

³¹ { TA \c 3 \s "TPC 53.083(b)" \l "TEX. PROP. CODE § 53.083(b)"}§ 53.083(b).

³² See Chapter 162, TEX. PROP. CODE.

³³ { TA \c 3 \s "TPC 53.057(b)" \l "TEX. PROP. CODE § 53.057(b)"}§ 53.057(b).

³⁴ { TA \s "TPC 53.057(b)"}§ 53.057(b).

³⁵ { TA \c 3 \s "TPC 53.057(e)" \l "TEX. PROP. CODE § 53.057(e)"}§ 53.057(e).

³⁶ { TA \c 3 \s "TPC 53.101(a)" \l "TEX. PROP. CODE § 53.101(a)"}§ 53.101(a).

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funds are intended to secure payment for all persons who supply labor and material for the project.³⁷ If the owner fails to comply with this retainage requirement, the owner can be *personally liable* for an amount equal to the 10% retainage, even if the owner has paid the original contractor the full contract price. While the owner's liability cannot generally exceed the 10% figure mandated by section 53.101, the owner may have additional liability depending upon whether additional funds were "trapped." Furthermore, while the statute provides that all claimants are to share the lien on the 10% "proportionately,"³⁸ at least one court has held that where the owner does not withhold the required retainage, the claimant was not required to establish his proportionate claim at trial and could recover the entire 10% figure.³⁹

To perfect a claim on the retained funds or the amount which should have been retained, a claimant must: (1) send all notices required by Chapter 53; and (2) file an affidavit claiming a lien not later than 30 days after the project is completed.⁴⁰ If the claimant fails to give proper notice and secure the lien, the owner may not be liable.

While the Property Code defines "completion" to mean the date of actual completion of the work, including any extras or changes orders reasonably required or contemplated under the original contract, other than warranty or repair work,⁴¹ the claimant should file the lien affidavit *at the earliest possible date*.

³⁷ { TA \c 3 \s "TPC 53.102" \l "TEX. PROP. CODE § 53.102"}§ 53.102.

³⁸ { TA \c 3 \s "TPC 53.105(b)" \l "TEX. PROP. CODE § 53.105(b)"}§ 53.105(b).

³⁹ { TA \c 1 \s "W & W v. Project" \l "W & W Floor Covering Co v. Project Acceptance Co., 412 S.W.2d 379 (Tex. Civ. App. Austin [3rd Dist.] 1967)"}W & W Floor Covering Co v. Project Acceptance Co., 412 S.W.2d 379 (Tex. Civ. App.–Austin [3rd Dist.] 1967).

⁴⁰ { TA \c 3 \s "TPC 53.103" \l "TEX. PROP. CODE § 53.103"}§ 53.103.

⁴¹ §§ 53.001(15) and 53.106(e).

Because of the numerous battles which were historically fought concerning the date of "completion," the legislature added a provision to the Property Code in 1989 which allows an owner to file a completion affidavit in the county records which now provides *prima facie* evidence of the date of completion.⁴² If an owner elects to file the affidavit of completion, it must send a copy of the affidavit to the original contractor when the affidavit is filed with the county. A copy must be mailed at the same time to any existing claimant which sent notice of lien liability to the owner. If an owner later receives a lien claim, the owner should send a copy of the affidavit to the claimant within ten days of receiving the lien claim. Furthermore, the legislature amended the lien laws in 1999 to define "completion" as including all work and extras, but excluding all warranty work or repairs.⁴³

E. LEGAL REQUIREMENTS FOR LIENS

After the pre-filing notices have been given, a lien affidavit must be prepared and filed in a timely manner. Section 53.054 requires the lien affidavit to *contain substantially* the following:

- (1) Sworn statement of the claim, including the amount;
- (2) Name and address of owner or reputed owner;
- (3) General statement of the kind of work done and materials furnished by claimant;
- (4) Name and address of person by whom the claimant was employed or to whom the materials or labor were furnished;
- (5) Name and address of original contractor;
- (6) A description, legally sufficient for identification, of the property sought to be charged with the lien;
- (7) The claimant's business address and mailing address; and

⁴² { TA \c 3 \s "TPC 53.106" \l "TEX. PROP. CODE § 53.106"}§ 53.106.

⁴³ See § 53.001(15).

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(8) A statement of the amount owed and, for contracts signed after September, 1997, a list of months when the work was performed and a statement of when the fund trapping notice was sent to the owner.

Prior to 1989, the name of the owner or reputed owner was only required *if known* by the claimant. Now, the burden is on the claimant to discover the owner or reputed owner's identity and include that information in the lien affidavit. Due to this change in the law, and to ensure that pre-filing notices are properly made, one should instruct the claimant to make written requests of the owner, original contractor and subcontractor, as soon as possible, for the following information:

- (1) A legal description of the property;
- (2) Whether there are any prior recorded liens or security interests on the real property, and if so, the name and address of the person having the lien or security interest;
- (3) The name and last known address of the owner and the general contractor;
- (4) Whether the owner, original contractor or subcontractor have furnished or have been furnished a payment bond, and if so, the name and last known address of the surety and a copy of the bond; and
- (5) A copy of the original contract and, if applicable, subcontract.⁴⁴

If the person from whom the information is sought does not have a direct contractual relationship with the claimant, the claimant should also offer to reimburse the person supplying information for its actual costs of up to \$25.⁴⁵

2. Legal Description of Property

There is no hard-and-fast rule as to what constitutes a *legally sufficient description* of property for purposes of lien affidavits. The Texas Supreme Court held that a description is sufficient

⁴⁴ See § 53.159.

⁴⁵ { TA \c 3 \s "TPC 53.159(e)" \l "TEX. PROP. CODE § 53.159(e)"}§ 53.159(e).

"if there appear enough in the description to enable a party familiar with the locality to identify the premises intended to be described with reasonable certainty, to the exclusion of others."⁴⁶ This rule has been recognized and followed.

Applying such a rule, however, can be problematic. For example, while describing property only by quantity and as part of a larger tract is generally void for uncertainty, adding additional information to the description which through introduction of extrinsic evidence makes the property identifiable by someone familiar with the area may be sufficient.⁴⁷

Street addresses should never be used. Descriptions of rural routes and box numbers, in the absence of appropriate extrinsic evidence, is insufficient. If work is performed on more than one lot, the claimant must allocate the value of the work among the separate lots. One should always endeavor to use metes-and-bounds or lot, block and subdivision descriptions whenever possible.

3. Legal Description of Work

Prior to 1961, it was necessary to include a detailed summarization of the materials furnished or work done in the lien affidavit. Since that time, however, Texas courts have been very liberal in interpreting the *general statement* language of section 53.054(a)(3). A lien describing the labor as "general contractor responsibilities" was held sufficient. While the affidavit may use any abbreviations or symbols *customary in the trade*,⁴⁸ it must be intelligible and gibberish will not suffice.

4. Legal Content of Affidavit

Section 53.054(a)(1) requires that the lien affidavit contain a sworn statement. An

⁴⁶ { TA \c 1 \s "Scholes v. Hughes" \l "Scholes & Goodall v. Hughes & Boswell et al., 77 Tex. 482, 14 S.W. 148 (1890)"}Scholes & Goodall v. Hughes & Boswell et al., 77 Tex. 482, 14 S.W. 148 (1890).

⁴⁷ See, e.g., *Pickett v. Bishop*, 148 Tex. 207, 223 S.W.2d 222 (1949) (added name of owner of property who owned only one piece of property within the larger tract).

⁴⁸ { TA \c 3 \s "TPC 53.054(c)" \l "TEX. PROP. CODE § 53.054(c)"}§ 53.054(c).

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"affidavit" which merely contains an acknowledgment is insufficient to satisfy the requirements of Chapter 53. While a sworn statement is required, an affidavit which was signed by the corporate claimant's attorney but did not contain a statement that it was made with personal knowledge was held to have substantially complied with the requirements of section 54.054(a)(1).⁴⁹ However, one should carefully read the *Gill* decision before relying upon its holding.

5. Curing Defects in Legal Descriptions

In the case of Texas Federal Sav. & Loan Ass'n v. Davis,⁵⁰ the lien claimant incorporated the legal description contained in the mechanic's lien contract into the lien affidavit. This description was not, however, the true legal description of the property. In rejecting the owner's claim that the lien was invalid due to an improper property description, the court relied upon the theory of mutual mistake of fact and ordered that the lien contract be reformed to enable the proper liening of the property.

F. LIEN AMOUNT

As a general rule, and subject to certain limitations arising out of prior payments by owners and the 10% retainage limitations, a mechanic's lien will generally be in the full amount due and owing the claimant.⁵¹ If the claimant has specially fabricated materials which have not been delivered or incorporated into the project, the lien will be reduced by the amount of the salvage value of the materials.⁵²

1. Full Performance

When the claimant has fully performed its contractual obligations, it is entitled to file a lien

for the full amount of money owed under the contract, *plus* any charges for *extra* work. If there is no money owed, there is no authorization for a lien to be filed. While the sales tax on items may be included in the lien amount, attorney's fees and prejudgment interest may not.

2. Partial Performance

Where the contractor *substantially completes* its work, it is entitled to recover and lien the property for the full contract price, *plus* extra work performed for the owner, *less* the cost to complete the work.⁵³ When a project is not completed, an original contractor's profit may be included in the lien amount only to the extent that it is considered compensation for services actually rendered as opposed to the contractor's loss because of an owner's breach.

The amount of a subcontractor's lien may not exceed: (1) an amount equal to the proportion of the total subcontract price that the sum of labor performed, materials furnished, materials specially fabricated, reasonable overhead costs incurred and proportionate profit margin bears to the total subcontract price, *minus* (2) the sum of previous payments received by the claimant on the subcontract.⁵⁴ Put more simply, the subcontractor can recover the actual costs of its labor and materials furnished *plus* a prorated portion of the reasonable overhead and profit for the job.

G. SERVICE OF AFFIDAVIT

Section 53.055(a) **now** requires that a filed lien affidavit be sent by certified or registered mail to the owner or reputed owner within five days of filing the affidavit. If the claimant is a derivative claimant, the affidavit must also be sent to the original contractor by certified or registered mail within the same time period.⁵⁵ For construction

⁴⁹ { TA \c 1 \s "Gill v. Int'l Supply" \l "*Gill Savings Ass'n v. International Supply*, 759 S.W.2d 697 (Tex. App.--Dallas 1988, writ denied)" } *Gill Savings Ass'n v. International Supply*, 759 S.W.2d 697 (Tex. App.--Dallas 1988, writ denied).

⁵⁰ { TA \s "Texas Fed. S&L v. Davis" } 668 S.W.2d 816 (Tex. App.--Dallas 1984, no writ).

⁵¹ { TA \s "TPC 53.023" } § 53.023.

⁵² { TA \c 3 \s "TPC 53.023(2)" \l "TEX. PROP. CODE § 53.023(2)" } § 53.023(2).

⁵³ { TA \c 1 \s "Herron v. Lackey" \l "*Herron v. Lackey*, 554 S.W.2d 708 (Tex. Civ. App.--Beaumont 1977), *aff'd*, 556 S.W.2d 246 (Tex. 1977)" } *Herron v. Lackey*, 554 S.W.2d 708 (Tex. Civ. App.--Beaumont 1977), *aff'd*, 556 S.W.2d 246 (Tex. 1977).

⁵⁴ { TA \c 3 \s "TPC 53.024" \l "TEX. PROP. CODE § 53.024" } § 53.024.

⁵⁵ { TA \c 3 \s "TPC 53.055(b)" \l "TEX. PROP. CODE § 53.055(b)" } § 53.055(b).

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contracts entered prior to September 1, 1999, the lien affidavit must be mailed **ONE DAY** after filing.

No lien may be perfected if a copy of the lien affidavit is not sent to the owner. Failure to send the notice within the time period established by section 53.055 will avoid the lien.⁵⁶ *Cabintree* is also fairly unique in that it is one of the few cases which recognizes the proposition that the mechanic's lien laws are drafted to also protect the owner.

Where the owner and contractor are, as a practical matter, the same people, notice to the contractor or the owner should be sufficient as notice to both.

There is case law to support the proposition that if the contractor is performing work at the time that a person purchases the realty or acquires a mortgage on the building, the person acquiring the mortgage has a duty to inquire as to whether labor or materials have been supplied within the statutory period for filing liens.⁵⁷ While failure to make such inquiry *may* excuse a subcontractor from giving timely notice of the filed lien affidavit under similar circumstances,⁵⁸ one should never rely on this theory.

H. FILING REQUIREMENTS

The lien affidavit must be filed with the county clerk of the county in which the property is

located or into which the railroad extends not later than the *15th day of the fourth calendar month* after the date on which the indebtedness accrues.⁵⁹ While the county clerk must record the lien affidavit, failure of the clerk to properly record or index a filed affidavit does not invalidate the lien.⁶⁰

The deadlines established for filing lien affidavits are mandatory. On the other hand, there is no prohibition to filing a lien affidavit *before* the indebtedness accrues.

While the deadlines are mandatory, the courts have liberally construed the *accrual of indebtedness* language. For example, replacement of glass broken in the shipment will extend the start point for accrual of indebtedness. An agreement to pay for materials at a specific time may trigger the accrual of indebtedness, even if the material was actually delivered earlier than the payment date.

1. Timing--Original Contractors

An *original contractor* must file the affidavit not later than the 15th day of the *fourth calendar month* after (1) the last day of the month in which the original contractor receives a written declaration by the owner that the contract is terminated, or (2) the last day of the month in which the original contract is completed, finally settled or terminated.⁶¹ Where contractor continues work after owner's breach, the date of completion or final settlement will be used for purposes of calculating the accrual of indebtedness period.⁶²

2. Timing--First Tier Subcontractors

⁵⁶ { TA \c 1 \s "Cabintree v. Schneider" \l "Cabintree, Inc. v. Schneider, 728 S.W.2d 395 (Tex. App. Houston [1st Dist.] 1986, err. ref'd)"}Cabintree, Inc. v. Schneider, 728 S.W.2d 395 (Tex. App.--Houston [1st Dist.] 1986, err. ref'd) (lien was timely filed, but not mailed to owner until two months after deadline for filing).

⁵⁷ { TA \c 1 \s "Woods v. Burns" \l "Woods v. Burns, 420 S.W.2d 425 (Tex. Civ. App.--Dallas 1967, writ ref'd n.r.e.)"}Woods v. Burns, 420 S.W.2d 425 (Tex. Civ. App.--Dallas 1967, writ ref'd n.r.e.); { TA \c 1 \s "Tomlinson v. Higginbotham" \l "Tomlinson v. Higginbotham Bros. & Co., 229 S.W.2d 920 (Tex. Civ. App.--Eastland 1950, no writ)"}Tomlinson v. Higginbotham Bros. & Co., 229 S.W.2d 920 (Tex. Civ. App.--Eastland 1950, no writ).

⁵⁸ See *Inman v. Clark*, 485 S.W.2d 372 (Tex. Civ. App.--Houston [1st Dist.] 1972, no writ).

⁵⁹ { TA \c 3 \s "TPC 53.052(a)" \l "TEX. PROP. CODE § 53.052(a)"}§ 53.052(a).

⁶⁰ { TA \c 3 \s "TPC 53.052(b)" \l "TEX. PROP. CODE § 53.052(b)"}§ 53.052(b).

⁶¹ §§ 53.052(a) and 53.053(b).

⁶² { TA \c 1 \s "Reliable v. Brown & Root" \l "Reliable Life Ins. Co. v. Brown & Root, Inc., 607 S.W.2d 621 (Tex. Civ. App.--Waco 1980, writ ref'd n.r.e.)"}Reliable Life Ins. Co. v. Brown & Root, Inc., 607 S.W.2d 621 (Tex. Civ. App.--Waco 1980, writ ref'd n.r.e.).

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A *first-tier subcontractor* must file the affidavit not later than the *15th day of the fourth calendar month* following the last month in which the first-tier subcontractor supplied work or material.⁶³

3. Timing--Lower Tier Subcontractors

Lower-tier subcontractors must file the affidavit not later than the *15th day of the fourth calendar month* following the last month in which the lower-tier subcontractor supplied work or material.⁶⁴

4. Timing--Specially Fabricated Materials

Indebtedness to fabricators of specially fabricated materials accrues on (1) the last day of the last month in which the materials were delivered, (2) the last day of the last month in which delivery of the last of the material would normally have been required at the job site, *or* (3) the last day of the month of any material breach or termination of the original contract by the owner, contractor or subcontractor to which the material was to be furnished.⁶⁵ Consequently, depending upon where the fabricator lies in the construction chain, the time period for filing a lien affidavit will vary.

Actual delivery of specially fabricated materials will trigger the calculation of the accrual period, even though that date was later than the date on which the materials should have been delivered.

5. Timing--Residential Contracts

For residential contracts, not necessarily ones for homestead, the lien affidavit must be filed by the 15th day of the third month after the debt accrues. This is a change effective September 1, 1997, and reduces deadlines on residential contracts by one month.

6. Timing--Retainage

While section 53.101 requires, among other things, that the affidavit be filed within 30

days after the work is completed in order to perfect a lien on the retained funds, this is not required when the owner fails to withhold the 10% retainage for the 30 day period so long as the ultimate lien affidavit is otherwise filed in a timely manner.

7. Examples for Perfecting Liens

a. Perfection by Original Contractors

An original contractor is a person contracting with an owner either directly or through an owner's agent.⁶⁶ There may be more than one original contractor.⁶⁷ Sometimes an owner will set up a shell or sham company as an intermediary to act as the "original contractor." The Property Code ignores this legal fiction by stating that contractors and suppliers contracting directly with the intermediary are deemed to be original contractors when: (1) the intermediary effectively controls or is controlled by the owner through ownership of voting stock, interlocking directorships, or otherwise; or (2) the contract between the owner and intermediary was made without good faith intention of the parties that the intermediary was to perform the contract.⁶⁸

The importance of this provision is three-fold to the party contracting with the sham company: first, the contractor will have a direct claim against the owner in the event of default or non-payment; second, the contractor will be entitled to a constitutional lien in certain circumstances; and third, the contractor will have one less notice to give for perfection of its statutory lien.

For an original contractor to perfect a statutory lien, the contractor must:

File an affidavit in the property records of the county where the project is located not later than the *15th day of the fourth calendar*

⁶³ §§ 53.052(a) and 53.053(c).

⁶⁴ §§ 53.052(a) and 53.053(c).

⁶⁵ { TA \c 3 \s "TPC 53.053(d)" \l "TEX. PROP. CODE § 53.053(d)"}§ 53.053(d).

⁶⁶ { TA \c 3 \s "TPC 53.001(7)" \l "TEX. PROP. CODE § 53.001(7)"}§ 53.001(7).

⁶⁷ { TA \c 3 \s "TPC 53.002" \l "TEX. PROP. CODE § 53.002"}§ 53.002.

⁶⁸ { TA \s "TPC 53.026"}§ 53.026.

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month after the *earlier* of the following events: (1) the last day of the month in which the original contractor receives a written declaration by the owner that the contract is terminated, or (2) the last day of the month in which the original contract is completed, finally settled or terminated.⁶⁹ The contents of the affidavit are set forth in section 53.054 and are more fully discussed below. *Note:* Warranty work should never be used for purposes of determining when the contract is completed.

Send a copy of the affidavit by registered or certified mail to the owner or reputed owner at the last known business or residence address by the day following filing the affidavit.⁷⁰ Failure to send timely notice of a filed lien affidavit will avoid a statutory lien.

While several courts have held that "substantial compliance" with filing and notice requirements is sufficient to perfect a lien, one should *never* rely on a substantial compliance theory and should in all circumstances strictly follow all notice and filing requirements for perfection.

No notice or filing is required for a constitutional lien, although the protection afforded by such lien is significantly less than its statutory counterpart. Constitutional liens are discussed at more length below.

b. Perfection by First-Tier Subcontractors

For a first-tier subcontractor (*i.e.*, a subcontractor or supplier with a direct contractual relationship with the original contractor) to perfect a statutory lien, the first-tier subcontractor must:

Send a registered or certified letter to both the owner or reputed owner

⁶⁹ §§ 53.052(a) and 53.053(b).

⁷⁰ { TA \s "TPC 53.055(a)"}§ 53.055(a).

and the original contractor informing them of any unpaid invoices not later than the *15th day of the third month* following *each* month in which all or part of the first-tier subcontractor's labor was performed or material delivered.⁷¹ While a copy of the first-tier subcontractor's statement or billing should be sufficient to satisfy this requirement,⁷² the first-tier subcontractor is urged to use a formal letter to avoid concerns arising out of unclear or illegible invoices. Furthermore, the notice should also contain the statutory language of section 53.056(d) to "trap funds" in the owner's possession.

File an affidavit in the property records of the county where the project is located not later than the *15th day of the fourth calendar month* following the last month in which the first-tier subcontractor supplied work or material.⁷³ *Note:* Warranty work should never be used to determine the last month in which the first-tier subcontractor supplied work or material.

Send a copy of the affidavit by registered or certified mail to the owner or reputed owner at the owner's last known business or residence address, and to the original contractor at the original contractor's last known business or residence address, within five

⁷¹ { TA \c 3 \s "TPC 53.056(b)" \l "TEX. PROP. CODE § 53.056(b)"}§ 53.056(b).

⁷² { TA \c 3 \s "TPC 53.056(f)" \l "TEX. PROP. CODE § 53.056(f)"}§ 53.056(f).

⁷³ §§ 53.052(a) and 53.053(c).

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days following filing the affidavit.⁷⁴

c. Perfection by Lower-Tier Subcontractors

For lower-tier subcontractors (*i.e.*, a subcontractor or supplier with a direct statutory lien) the lower-tier subcontractor must:

Send a registered or certified letter to the original contractor informing it that funds are due the lower-tier subcontractor not later than the *15th day of the second month* following *each* month in which the lower-tier subcontractor has supplied labor or materials.

Send a registered or certified letter to both the owner or reputed owner *and* the original contractor informing them of the unpaid balance not later than the *15th day of the third month* following *each* month in which all or part of the lower-tier subcontractor's labor was performed or material delivered.⁷⁵ While a copy of the lower-tier subcontractor's statement or billing should be sufficient to satisfy this requirement,⁷⁶ the lower-tier subcontractor is urged to use a formal letter to avoid concerns arising out of unclear or illegible invoices. This notice should also include the "fund trapping" language set forth in section 53.056(d).

File an affidavit in the property records of the county where the project is located not later than the *15th day of the fourth calendar month* following the last month in which the lower-tier subcontractor

supplied work or material.⁷⁷

Note: Warranty work should never be used to determine the last month in which the lower-tier subcontractor supplied work or material.

Send a copy of the affidavit by registered or certified mail to the owner or reputed owner at the owner's last known business or residence address, and to the original contractor at the original contractor's last known business or residence address within five days after filing the affidavit.⁷⁸

d. Perfection by Design Professional

For contracts entered after September 1, 1995, architects and engineers (holding a contract with the owner) must file a lien affidavit by the *15th day of the fourth calendar month* after the *earlier* of the following events: (1) the last day of the month in which the original contractor receives a written declaration by the owner that the contract is terminated, or (2) the last day of the month in which the original contract is completed, finally settled or terminated.⁷⁹ For contracts entered into before this date, the contract itself must be recorded.

e. Perfection for Specially Fabricated Materials

Because the entity which specially fabricates materials is given extra protection under the lien laws,⁸⁰ that claimant, no matter where it falls in the construction chain, must take steps *in addition to* those described in paragraphs (a) through (c) above to create a lien for materials which are fabricated but not incorporated into the project. A notice must be sent by registered or certified mail to the last known business or residence address of the owner or reputed owner

⁷⁴ { TA \s "TPC 53.055(a)"}§ 53.055(a).

⁷⁵ { TA \s "TPC 53.056(b)"}§ 53.056(b).

⁷⁶ { TA \s "TPC 53.056(f)"}§ 53.056(f).

⁷⁷ §§ 53.052(a) and 53.053(c).

⁷⁸ { TA \s "TPC 53.055(a)"}§ 53.055(a).

⁷⁹ { TA \s "TPC 53.052(a)"}§ 53.052(a), { TA \s "TPC 53.053(b)"}§ 53.053(b).

⁸⁰ *See, e.g.*, § 53.021.

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(for first-tier fabricators) *and* to the original contractor (for lower-tier fabricators) not later than the *15th day of the second month* after the month in which the claimant receives and accepts the order for the material.⁸¹ The notice must contain (1) a statement that the order has been received and accepted; and (2) the price of the order.⁸²

If the fabricator has given the notices required by section 53.056, but has not given the notices required by section 53.058, then the lien will only be valid as to the materials actually delivered to the job.⁸³ *Note:* If the agreement to provide specially fabricated materials contains a retainage agreement and the fabricator gives the notices required under section 53.057, then no notice need be given under section 53.058.⁸⁴

f. Perfection by a Landscape Contractor

Because professional landscapers and nurserymen sometimes faced challenges to the validity of a lien for such work, the industry lobbied for a change to the lien statute to avoid ambiguity. Section 53.021 of the Property Code now provides that any person under a contract directly with an owner who provided labor, plant material, or other supplies for landscaping improvements is entitled to a mechanic's lien. A landscape contractor or supplier must file an affidavit claiming a mechanic's lien to perfect its rights. The landscaper contractor's lien rights would be equivalent to those of the architect, engineer, or surveyor that also contracted with an owner.

This clarification should remove any doubt as to whether a landscape contractor or nursery supplier has lien rights, if it contracts directly with an owner. Those suppliers and contractors who act as subcontractors must still

comply with the statute's notice and lien filing provisions, as they apply to all subcontractors.

I. RESIDENTIAL CONTRACTS

The 1997 state legislature completely modified the law applicable to residential construction contracts. The prior requirements to create a lien for constructing or repairing a homestead have been re-numbered and include the following requirements:

- (1) The owner *and* spouse must execute a written contract before labor or materials are furnished.⁸⁵
- (2) The contract must be filed with the county clerk in the county where the homestead is located.⁸⁶ If the original contractor files the contract, such filing inures to all derivative claimants.⁸⁷
- (3) The notice to be given to the owner to trap funds must contain the following:

If a subcontractor or supplier who furnishes materials or performs labor for construction of improvements on your property is not paid, your property may be subject to a lien for the unpaid amount if:

- (1) after receiving notice of the unpaid claim from the claimant you fail to withhold payment to your contractor that is sufficient to cover the unpaid claim until the dispute is resolved; or

⁸¹ { TA \c 3 \s "TPC 53.058(b)" \l "TEX. PROP. CODE § 53.058(b)"}§ 53.058(b).

⁸² { TA \c 3 \s "TPC 53.058(c)" \l "TEX. PROP. CODE § 53.058(c)"}§ 53.058(c).

⁸³ { TA \c 3 \s "TPC 53.058(f)" \l "TEX. PROP. CODE § 53.058(f)"}§ 53.058(f).

⁸⁴ { TA \c 3 \s "TPC 53.058(g)" \l "TEX. PROP. CODE § 53.058(g)"}§ 53.058(g).

⁸⁵ { TA \c 3 \s "TPC 53.254(a-c)" \l "TEX. PROP. CODE § 53.254(a-c)"}§ 53.254(a-c).

⁸⁶ { TA \c 3 \s "TPC 53.254(e)" \l "TEX. PROP. CODE § 53.254(e)"}§ 53.254(e).

⁸⁷ { TA \c 3 \s "TPC 53.254(d)" \l "TEX. PROP. CODE § 53.254(d)"}§ 53.254(d).

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(2) during construction and for 30 days after completion of construction, you fail to retain 10 percent of the contract price or 10 percent of the value of the work performed by your contractor

If you have complied with the law regarding the ten percent retainage and you have withheld payment to the contractor sufficient to cover any written notice of claim and have paid that amount, if any, to the claimant, any lien claim filed on your property by a subcontractor or supplier, other than a person who contracted directly with you, will not be a valid lien on your property. In addition, except for the required ten percent retainage, you are not liable to a subcontractor or supplier for any amount paid to your contractor before you received written notice of the claim.⁸⁸

(4) A lien affidavit must contain the following notice conspicuously printed, stamped or typed in a size equal to at least 10-point boldface or computer equivalent, at the top of the page:

"NOTICE: THIS IS NOT A LIEN. THIS IS ONLY AN AFFIDAVIT CLAIMING A LIEN."

The new requirements for residential construction are *not limited to homesteads*. Rather, the requirements extend to construction of houses, duplexes, and the like for an owner who resides in the home. Accordingly, while the prior law provided that new construction would not be considered "on a homestead," the amended statute avoids this distinction. In addition to the other requirements, a subcontractor or supplier must notify the owner and general contractor of unpaid invoices by the 15th day of the second month after work was performed. The notice on a homestead must also contain an additional warning about retainage requirements and personal liability.

Further, on residential construction projects, the contractor must provide a printed disclosure statement, a list of subcontractors, and

⁸⁸ { TA \s "TPC 53.254"}§ 53.254.

itemized bills-paid affidavits. Moreover, the list of subcontractors with balances owed to them must be supplemented when each payment application is submitted. The obligations to provide information on subcontractors can be waived in a signed agreement. The amended statute has further requirements in addition to those set forth herein. Accordingly, those contractors in the business of residential construction and remodeling must provide additional information. However, the statute provides that the failure to provide some of the disclosures will not affect the validity of any mechanic's lien.

Unlike statutory liens on non-homestead properties, a lien on a homestead is valid only if the claimant *strictly complies* with Chapter 53 and any other relevant constitutional or statutory provision.⁸⁹ The following situations have been held sufficient to defeat a statutory lien on a homestead:

- 1.Lack of executed written contract.⁹⁰
- 2.Lack of signature of both spouses.⁹¹
- 3.Written contract not executed before work is begun or material delivered.⁹²
- 4.Failure to substantially perform the contract.⁹³

⁸⁹ See TEX. CONST. art. XVI, § 50.

⁹⁰ { TA \c 1 \s "Moray v. Griggs" \l "Moray v. Griggs, 713 S.W.2d 753 (Tex. App.--Houston [1st Dist.] 1986, writ ref'd)" }Moray v. Griggs, 713 S.W.2d 753 (Tex. App.--Houston [1st Dist.] 1986, writ ref'd).

⁹¹ { TA \c 1 \s "Tezel & Cotter v. Roark" \l "Tezel & Cotter v. Roark, 301 S.W.2d 179 (Tex. Civ. App.--San Antonio 1957, writ ref'd)" }Tezel & Cotter v. Roark, 301 S.W.2d 179 (Tex. Civ. App.--San Antonio 1957, writ ref'd).

⁹² { TA \c 1 \s "Zeller v. Univ. Savings" \l "Zeller v. University Savings Ass'n, 580 S.W.2d 658 (Tex. Civ. App.--Houston [14th Dist.] 1979, no writ)" }Zeller v. University Savings Ass'n, 580 S.W.2d 658 (Tex. Civ. App.--Houston [14th Dist.] 1979, no writ).

⁹³ { TA \c 1 \s "Houston Lumber v. Wockenfuss" \l "Houston Lumber Supply Co. v. Wockenfuss, 386 S.W.2d 330 (Tex. Civ. App.--Houston 1965, writ ref'd n. r. e)" }Houston Lumber Supply Co. v.

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Furthermore, it appears that a failure to strictly comply with the technical requirements may not be waived or ratified.

Where work is started on property which is not a homestead, but acquires homestead status during the performance of the work, the homestead laws for perfecting a lien would not apply because of the relation-back doctrine which states that a lien is created at the inception of work.

In other respects, the lien procedures for residential construction are identical to those for commercial construction.

J. LEASEHOLDS

A mechanic's lien can attach only to the interest of the person contracting for construction; therefore, where a lessee contracts for improvements, any lien attaches only to the leasehold interest and not the underlying property. Therefore, unless the owner of the property contracts for the leasehold improvements, only the leasehold interest of the lessee can be subjected to a lien. At best, the claimant should investigate whether the lessee may be characterized as the owner's agent--whether through express, implied or apparent authority--so as to enable a lien to be placed on the underlying property. Mere knowledge of the owner that leasehold improvements are being made do not, without more, constitute ratification.

K. PRIVATE BOND CLAIMS

Bond claims on a project are of two basic types. First, if a subcontractor or supplier has filed a lien affidavit against a project, an owner may obtain an Indemnity Bond to clear title to the realty from these existing liens. Second, a contractor or subcontractor may be obligated to obtain a Payment Bond in the amount of the contract to protect the owner. In either situation, the owners' property will be protected from lien claims.

A subcontractor or supplier has two formal sources for information as to the identify of

an insurance company providing a bond on a project. First, the potential claimant may make a written request on the owner or general contractor to provide the name and address of the surety, along with a copy of the payment bond. Second, the real property records for the county in which the construction occurs should have a copy of the construction contract and the payment bond, as the owner is obligated to file copies of these items.

L. INDEMNITY BONDS

In order to allow an owner to sell property encumbered with a disputed lien, the Texas Property Code provides for a procedure which is commonly known as "bonding around" a lien.⁹⁴ The same procedure may also be used by a general contractor who needs to remove a disputed subcontractor's lien from a project, while still keeping the right to dispute the claim.

To bond around the claim the owner or general contractor provides an indemnity bond, which is sometimes called a Subchapter H Bond. The indemnity bond clears the title to real property which has had lien affidavits filed against it by subcontractors or suppliers. In order to be effective, it must be written to comply with the statutory requirements found in section 53.172. Among other things, section 53.172 requires that the bond refer to each lien claimed in a manner sufficient to identify it, be payable to the party or parties claiming the lien in a specified amount, be executed by the party filing the bond (the principal) and by a corporate surety, and provide that, if the claim is proved to be valid, the principal and the surety will pay the claimant the amount it is entitled to.

The corporate surety generally charges as a fee a percentage of the amount of the bond. In addition to this fee, the surety agreement will provide that, if payment is ultimately made on the bond, the principal will indemnify the surety for the amounts advanced. Unless a corporate principal has a very strong financial statement, the surety will require personal guaranties from the controlling individuals of the principal.

Wockenfuss, 386 S.W.2d 330 (Tex. Civ. App.--Houston 1965, writ ref'd n. r. e).

⁹⁴ { TA \s "TPC 53.172"}§ 53.172.

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Once the bond has been issued by the corporate surety, it is then filed in the deed records of the county where the property is located. The Property Code provides that after filing, the county clerk issues a notice of the bond which is served on all claimants. After it has been served, the notice with a completed return is filed in the deed records.⁹⁵

Bonds to indemnify against liens filed on property are effective to discharge the lien upon "filing and notice" of the bond. Service of "notice" on the lien claimant can now be accomplished by mailing. The notice of the filing of the bond should be sent by certified mail to the address which the claimant stated in the lien affidavit. Prior to the 1999 revisions to the Texas Property Code, it was necessary to obtain personal service of the notice on the claimant.

After filing the bond, notice and return, a purchaser, title company or lender is protected to the same extent as if the lien claimant had filed a release of lien in the real property records.⁹⁶

M. PAYMENT BONDS

Large construction projects typically have many levels of participants and, correspondingly, many levels of obligations. While each participant may have as its goal the successful completion of the project, sometimes the more immediate need to make a profit on the job may override concerns about the project as a whole.

In a typical scenario, the owner/developer borrows the funds to buy the property and build the building. He grants a lien to his lender on the land and improvements to secure the loan. He enters into a contract with a general contractor for the construction. The general contractor enters into subcontracts for the many component parts of the project--heating and air, plumbing, paving, etc. Each of the subcontractors has suppliers and materialmen or in some cases second-tier

subcontractors. Each of these parties has different obligations depending on their level of participation in the project. Consequently, there may be a number of forms of payment bonds on any given project.

N. SUITS ON INDEMNITY BONDS

Section 53.175 of the Property Code establishes the statute of limitations for filing suit on an indemnity bond. A claimant may not sue on the bond later than one year after the date the notice is served or after the date on which the underlying claim becomes unenforceable. The proper filing of an indemnity bond eliminates a claimant's right to foreclose its lien, and makes action against the bond the claimant's only recourse. Thus, although Section 53.158 allows a claimant up to two years to foreclose its lien, an indemnity bond can have the effect of shortening the time for a lien claimant to file suit.

O. SUITS ON PAYMENT BONDS

Section 53.208(d) of the Property Code establishes a one-year statute of limitations for filing suit on a payment bond, if the bond is recorded at the time the lien is filed.

If the bond has not yet been recorded, the statute provides that the claimant must file suit within two years following perfection of the claim. Venue on a suit to collect against a payment bond is mandatory in the county in which the property is located.⁹⁷

If a payment bond has been properly prepared and filed of record in accordance with section 53.201 *et seq.*, a claimant may not file suit against the owner or the owner's property. The claimant's only recourse is against the payment bond. Any lien that the claimant files is considered discharged of record.⁹⁸

V. EXTINGUISHING INVALID LIENS

In 1999, the Texas Property Code was revised to provide a summary procedure to enable

⁹⁵ { TA \c 3 \s "TPC 53.173" \l "TEX. PROP. CODE § 53.173"}§ 53.173.

⁹⁶ { TA \c 3 \s "TPC 53.174(b)" \l "TEX. PROP. CODE § 53.174(b)"}§ 53.174(b).

⁹⁷ { TA \c 3 \s "TPC 53.208(c)" \l "TEX. PROP. CODE § 53.208(c)"}§ 53.208(c).

⁹⁸ §§ 53.201(b) and 53.157(5).

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a party confronted with an invalid lien to file suit to have the lien removed.⁹⁹

The provision is available to any party, whether an owner or a general contractor, and provides for relief on an expedited basis. The party objecting to the validity of a lien may file a motion to remove the lien. The motion may be granted only for certain specified defects, including failure to give proper notice and failure to properly file the lien affidavit. Additionally, a lien may be removed if the party seeking its removal deposits all funds subject to the notice with the court. Section 53.160 requires the court to "promptly determine" a motion filed to remove a lien under that section.

VI. SELECT BANKRUPTCY ISSUES

It is now apparent that the statutory requirements for protecting the rights of a claimant to payment are specific and exacting. This statutory scheme can be a viable source of payment or, as likely, a source of frustration, even for a deserving creditor. However, the lien statutes also create unique issues and problems when a bankruptcy is encountered. The rights of all parties involved may be severely impacted by virtue of a bankruptcy proceeding, and understanding some of the more difficult issues is worth considering. Select issues are discussed below.

A. CONSTRUCTION TRUST FUNDS

Like many other states, Texas maintains a statute creating an express trust of construction contract proceeds for the benefit of subcontractors, their laborers, etc.¹⁰⁰ Texas unequivocally holds that neither a contractor nor its creditors, including the United States government, are entitled to the funds held by the owner when the amount of claims to the funds exceeds the funds still in the hands of the owner.¹⁰¹ The Fifth Circuit has

endorsed the *Penden Iron* court's analysis and extended that holding by concluding that the retained funds are not part of the bankruptcy estate.¹⁰² Because the retained funds are not part of the bankruptcy estate, arguably the Bankruptcy Court does not have jurisdiction over the funds or their disbursement.¹⁰³

in the retained funds that would prevent setoff. See *First Nat. Bank v. Smith*, 160 S.W. 311, 313 (Tex. Civ. App.--Dallas 1913, writ ref'd) (holding that an assignee of the contractor is subject to an owner's right to offset); see also *S.F.S.G. v. Huitt*, 1990 Tex. App. Lexis 1107, *8 (Tex. App.--Houston [14th Dist.] 1990, no writ) (unpublished opinion holding that factoring company is junior to owner's and surety company's right to offset money expended in completing job against contract proceeds).

¹⁰²*Green v. H.E. Butt Found.*, 217 F.2d 553, 554 (5th Cir. 1954). In *H.E. Butt*, the contractor completed construction of a swimming pool prior to bankruptcy, but failed to pay subcontractors pursuant to the contract. The contract contained a provision that said, in effect, that final payment to the contractor shall not become due until the contractor delivers to the owner a complete release of all liens arising out of the contract...and that if any lien remains unsatisfied after all payments are made, the contractor shall refund to the owner all moneys that the latter may be compelled to pay in discharging such a lien. The owner withheld payment of the balance due under the contract in order to satisfy the claims of laborers, mechanics and materialmen, who perfected their liens prior to the filing of the petition in bankruptcy by the contractor. As such, the Court explained:

Under the lien laws of Texas, the H.E. Butt Foundation was relieved of its indebtedness to the contractor as soon as the above-mentioned liens were filed and perfected. Such liens seize and appropriate for the benefit of the lienors any money in the hands of the owner that is due or may become due and payable to the contractor. This appropriated fund is not a debt due the bankrupt, and does not fall into the hands of the trustee under the fiction of constructive possession.

¹⁰³ See *Perry v. Wood*, 63 F.2d 257, 257 (5th Cir. 1933); *Fiberglass Specialty Co. v. Bor-Son Corp.*, 678 F.2d 78, 80 (8th Cir.), cert. denied, 405 U.S. 990 (1982). In *Perry*, the owner interpleaded into the registry of the state court the balance due to the contractor, who had defaulted under the terms of the contract. Thereafter, an involuntary petition was filed against the Debtor. The issue was who was entitled to the funds: the unpaid subcontractors or the chapter 7 trustee? The Court held:

⁹⁹ { TA \s "TPC 53.160"}§ 53.160.

¹⁰⁰ { TA \c 3 \s "TPC 162.001" \l "TEX. PROP. CODE ANN. § 162.001"}TEX. PROP. CODE § 162.001.

¹⁰¹ See *United States v. Penden Iron & Steel Co.*, 330 S.W.2d 635, 637 (Tex. Civ. App.--Texarkana 1959, writ ref'd n.r.e.). Likewise, an entity such as a bank, which asserts an ownership interest in the contract proceeds, does not have any senior interest

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B. RELIEF FROM THE AUTOMATIC STAY

The automatic stay is extremely broad in scope and applies to almost any type of action taken against the debtor or property of the estate.¹⁰⁴ The automatic stay comes into effect upon the filing of the bankruptcy petition. Subsections (a)(1) through (8) of section 362 of the Bankruptcy Code list the numerous types of actions which are automatically prohibited once a petition for relief is filed. Subsection (b) lists a number of specific acts which are not stayed by the filing of the bankruptcy petition.

A thorough discussion of the scope of the automatic stay is beyond the parameters of this article. As discussed above, the Texas Property Code requires lien claimants to record their liens within a statutorily specified time limit in order to perfect them. Obviously, since the automatic stay prevents actions to seize estate property or perfect interests in estate property, an intervening bankruptcy petition combined with the passage of time could act to deprive lien claimants of the protection contemplated for them by the Texas Property Code were it not for the exception provided in 11 U.S.C. § 362(b)(3).

Section 362(b)(3) provides:

- (b) The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay;

“The trustee in bankruptcy acquired no better title to the fund in the registry of the state court than the bankrupt had at the time the petition was filed. (citations omitted). Under the Texas lien laws as well as by an expressed provision of the construction contract, the owner of the pipe line, which had become subject to liens for labor and material, had the right to retain an amount sufficient to satisfy the liens and to deduct that amount from the contract price. Laborers and materialmen are given preference over other creditors of the contractor.”

¹⁰⁴ { TA \c 2 \s "11 U.S.C. 362" \l "11 U.S.C. § 362"}11 U.S.C. § 362.

(3)under subsection (a) of this section, 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 power 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.

This provision alleviates the hardship of the automatic stay by incorporating the provisions of 11 U.S.C. § 546(b) permitting mechanics and materialmen to perfect their liens post-petition by giving notice. Section 546(b) provides an exception to the general rule that the petition stays actions to perfect an interest and allows the post petition perfection of a lien in limited circumstances.¹⁰⁵

Section 546(b)(2) states:

- (2) if –
 - (A) a law described in paragraph (1) requires seizure of such property or commencement of an action to accomplish such perfection, or maintenance or continuation of perfection of an interest in property; and
 - (B) such property has not been seized or such an action has not been commenced before the date of the filing of the petition;such interest in such property shall be perfected, or perfection of such interest shall be maintained or continued, by giving notice within the time fixed by such law

¹⁰⁵ { TA \c 1 \s "In re Fullop" \l "In re Fullop, 6 F.3d 422 (7th Cir. 1993)}In re Fullop, 6 F.3d 422, 430 (7th Cir. 1993).

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for such seizure or such commencement.

Pursuant to section 546(b), if state law requires the seizure of property or the commencement of an action to perfect a lien and such actions have not been taken pre-petition, then the lien may be perfected post-petition by giving notice within the time fixed under state law for seizure or commencement of an action.¹⁰⁶

Section 546 does not specify what type of notice is sufficient and, accordingly, there has been discussion by a number of courts as to what type of notice will suffice. In the Fifth Circuit, the lead case is *In re Village Properties*.¹⁰⁷ In *Village Properties*, the Court discusses perfection by notice in an analogous situation. In that case, the lienholder of an apartment building was required under state law to take action which would violate the automatic stay in order to perfect its assignment of rents. The Fifth Circuit found that because a state court receivership action was stayed, the filing of a notice in the bankruptcy case by the lienholder was sufficient to perfect its interest.¹⁰⁸

While recording a lien in order to perfect the lien is not prohibited by section 362, bringing suit to enforce the lien is a violation of the automatic stay. Section 546(b) deals expressly with the perfection of a property interest existing as of the petition date and not the enforcement of

an interest that has been perfected prior to bankruptcy.¹⁰⁹

If a state statute requires that the claimant perfect its lien by filing and then file suit to enforce the lien, this creates a dilemma such as that discussed by the court in the case of *In re Hunters Run Ltd. Partnership*.¹¹⁰ In that case, a cement contractor in Washington state had perfected his lien by recording it pre-petition. However, the state statute only allowed the lien to remain in effect for eight months unless an action was commenced to enforce it. Since such an action would violate the automatic stay, the contractor faced the dilemma of losing his lien or risking sanctions for violating the stay. However, the court held that section 108(c) operated to toll the limitations period governing the life of statutory liens, thus preserving the contractor's lien.¹¹¹

Courts have distinguished actions to perfect a lien from actions to enforce a lien in the context of section 108(c) just as they have in the context of section 362. Furthermore, it has been held that section 108(c) does not create a separate tolling provision, but simply extends for the specified period an applicable statute of limitations that has expired during the operation of the stay.¹¹²

While the *Hunters Run* court treated the requirement that the claimant file suit within eight months as a form of limitations, the court in

¹⁰⁶ See, e.g., *In re Yobe Electric, Inc.*, 728 F.2d 207 (3rd Cir. 1984).

¹⁰⁷ { TA \s "In re Village Properties"}723 F.2d 441 (5th Cir. 1984), cert. denied, 466 US 974, 80 L.Ed 2d 823, 104 S. Ct. 2350 (1984).

¹⁰⁸ Similarly, the court in *Roofing Concepts v. Kenyon industries, Inc. (In re Coated Sales)*, 147 B.R. 842 (S.D. N.Y. 1992) found the filing of a secured claim in the bankruptcy case to be sufficient notice under section 546. But cf. *Stoehner v. Horizon Fabricators*, 153 B.R. 840 (D.Minn. 1993) where the claimant's actions to perfect its lien were held to be insufficient. In that case, however, the claimant failed to file an affidavit along with the notice of its lien as required by state law. In addition, it had failed to provide notice to the debtor to which it was a supplier.

¹⁰⁹ { TA \c 4 \s "Collier, ¶ 546.03[2], ¶ 546-21" \l "Collier on Bankruptcy, ¶ 546.03[2], ¶ 546-21 and N. 11 (15th Ed. Rev.)"}*Collier on Bankruptcy*, ¶ 546.03[2], ¶ 546-21 and N. 11 (15th Ed. Rev.). See { TA \c 1 \s "In re Houts" \l "In re Houts, 23 B.R. 705 (Bankr. W. D. Mo. 1982)" }*In re Houts*, 23 B.R. 705, 707 (Bankr. W. D. Mo. 1982) ("the courts distinguish, and properly so, between the act of perfecting the lien and the act of attempting to enforce it.").

¹¹⁰ { TA \s "In re Hunters Run"}875 F.2d 1425 (9th Cir. 1989).

¹¹¹ See also *In re Richardson Builders*, 123 B.R. 736 (Bankr. W.D. VA. 1990).

¹¹² { TA \c 1 \s "Rogers v. Corrosion Products" \l "Rogers v. Corrosion Products, 42 F.3d 292 (5th Cir. 1995)" }*Rogers v. Corrosion Products*, 42 F.3d 292 (5th Cir. 1995).

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Coated Sales, discussed above, looked at a similar requirement under New York law in a somewhat different light. In *Coated Sales*, the court held that when the state law method for perfecting a lien post-petition requires filing an enforcement action, section 546(b) supercedes the state law and allows perfection by notice within the applicable time period. On the facts of the case before it, the District Court found that the filing of a secured claim in the bankruptcy case satisfied the notice requirements of section 546(b).¹¹³

Because section 362(b)(3) provides an exception to the automatic stay for actions taken to perfect liens under section 546, courts have found unpersuasive the argument that the filing of a bankruptcy case should extend the time for recording a lien. In *Knopiler v. Addison Building Material (In re Germansen Decorating Inc.)*,¹¹⁴ the trustee of a bankrupt subcontractor sought payment from the general contractor on the project. The general contractor refused to pay without mechanic's lien waivers from each of the general contractor's suppliers. The trustee filed a declaratory judgment action against the supplier seeking a determination that the supplier's liens were unperfected because it had not given timely notice as required under the state statute. The court found that the supplier/lien claimant waited until three months after the bankruptcy to perfect, or, in other words, five months after final delivery. However, the state statute provided that perfection must be within four months of final delivery or it does not relate back as against intervening claimants. Accordingly, the supplier/claimant remained unperfected and its lien claim failed against the trustee's exercise of his strong arm powers under 11 U.S.C. § 544(a).

As a general rule, the section 362(a) automatic stay applies only to the debtor and does not apply to guarantors, sureties, insurers or other persons liable on the debt.¹¹⁵ There are exceptions

to this general rule. For example, if the debtor is an indispensable party to the litigation, the stay may apply.

Moreover, the stay may be held to apply to protect third party guarantors or sureties where a judgment against the third party is in effect a judgment against the debtor or where the resolution of the issues being litigated would, as a practical matter, be binding on the debtor.¹¹⁶ Generally, however, courts have been reluctant to extend the stay to protect third parties unless the case at issue involved the sort of "unusual circumstances" present in *A. H. Robins*.¹¹⁷

Exceptions notwithstanding, the automatic stay will not protect third parties. Thus, in the case of an owner's bankruptcy, an unpaid subcontractor could proceed against the general contractor pursuant to the terms of the contract. An unpaid subcontractor could also sue the surety under a payment bond covering the project. Conversely, in a bankruptcy involving a contractor, even the fact that the owner paid the contract in full, the unpaid suppliers and subcontractors can sue the owner or assert a lien against its property and the stay may not be applicable.¹¹⁸

¹¹³ { TA \s "Roofing Concepts v. Kenyon"}*Coated Sales*, 147 B.R. at 846.

¹¹⁴ { TA \s "Knopiler v. Addison"}149 B.R. 522 (Bankr. N.D. Ill. 1993).

¹¹⁵ { TA \c 1 \s "U.S. v. Wright" \l "United States v. Wright, 57 F.3d 561 (7th Cir. 1995)}*United States v. Wright*, 57 F.3d 561, 562 (7th Cir. 1995).

¹¹⁶ See *A. H. Robins Co. v. Piccinin*, 788 F.2d 994 (4th Cir.) *Cert. denied*, 479 U.S. 876, 107 S. Ct. 251, 93 L. Ed 2d 177 (1986).

¹¹⁷ See *In re Petroleum Piping Contractors*, 211 B.R. 290 (Bankr. N.D. Ind. 1997), where the court in a lengthy opinion citing numerous cases discusses perfection pursuant to section 546(b), relation back and tolling under section 108 before finally concluding that unusual circumstances don't exist and it would be proper to permit the claimant to bring suit under the bond.

¹¹⁸ See, also, *In re Middleton & Dugger Plumbing & Heating v. Richardson Builders*, 123 B.R. 736 (Bankr. W.D. Va. 1990). In that case, the Bankruptcy Court stayed a subcontractor's action to enforce a lien against the non-debtor owner in part because the debtor-contractor was a necessary party. However, the Bankruptcy Court also suggested that since enforcement of the lien against the owner would result in an assertion of a setoff against the amounts owed to the general contractor, the stay should apply.

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In *Universal Bonding Ins. Co. v. Gittons and Sprinkle Enterprises*,¹¹⁹ a case which involved the bankruptcy of a general contractor, the bonding company opposed a motion by the debtor for a declaratory judgment that the amounts remaining unpaid under its contracts were property of the estate under Bankruptcy Code section 541 and, therefore, must be paid to it. The bonding company argued that state law imposed a constructive trust on those funds for the benefit of materialmen and subcontractors on the jobs. If the funds were released to the debtor and used to pay its general unsecured creditors, the surety argued that it would be left fully liable for the unpaid claims. Notwithstanding the surety's argument to the contrary, the court found that the funds must be paid to the debtor. Citing *In re Quality Holstein Leasing*,¹²⁰ however, the Third Circuit found that once the funds were paid to the debtor, the debtor must hold them in trust. The estate obtains no greater ownership right over the payments than the debtor itself would have acquired prior to the bankruptcy filing. The debtor's bankruptcy estate may return legal title, but the beneficiaries of the trust (namely, the laborers, materialmen and the surety, after satisfying the claims of laborers and materialmen) may reclaim their equitable interests in the trust fund so created through Bankruptcy Court proceedings.¹²¹

C. SETOFF RIGHTS UNDER 11 U.S.C. § 553

For property owners, unpaid balances owed to subcontractors and suppliers can pose an interesting dilemma: on the one hand, the owner can expect that those unpaid subcontractors and suppliers will file and attempt to enforce mechanics' and materialmen's liens against the owner's property. On the other hand, the project owner also faces the possibility of a turnover action by the trustee or debtor-in-possession who claims it is owed money for work performed.

¹¹⁹ { TA \s "Universal Bonding v. Gittons"}960 F.2d 366 (3rd Cir. 1992).

¹²⁰ { TA \s "In re Quality Holstein"}752 F.2d 1009 (5th Cir. 1985).

¹²¹ { TA \s "Universal Bonding v. Gittons"}*Universal Bonding*, 960 F.2d at 372.

Thus, the owner faces the potential for double or multiple liability.¹²² This scenario is often the first problem faced by the unsuspecting property owner when a bankruptcy is filed.

One provision of the Bankruptcy Code that may be helpful for the project owner facing the potential of multiple liability is 11 U.S.C. § 553. Section 553 of the Bankruptcy Code expressly preserves the state law right of setoff.

Section 553 of the Bankruptcy Code provides, in pertinent part:

(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case.¹²³

Section 553(a) permits creditors to set off mutual, prepetition claims and debts with the debtor if such setoff would be recognized under nonbankruptcy law.¹²⁴ The right to setoff is explicitly encompassed by the automatic stay, and thus a project owner seeking to take advantage of section 553 must obtain relief from the stay before exercising any rights of setoff.¹²⁵ The automatic stay, however, "does not defeat the right of setoff; rather, setoff is merely stayed pending an "orderly examination of the debtor's and creditor's rights."¹²⁶

¹²² See Lawrence Ponoroff, *Construction Claims in Bankruptcy: Making the Best of a Bad Situation*, 11 *Bankr. Dev. J.* 343, 388 (1994/1995) (hereinafter, "Ponoroff").

¹²³ { TA \s "11 U.S.C. 553"}11 U.S.C. § 553.

¹²⁴ { TA \c 1 \s "In re Corland Corp." \l "*In re Corland Corp.*, 967 F.2d 1069 (5th Cir. 1992)" \l "*In re Corland Corp.*, 967 F.2d 1069, 1076 (5th Cir. 1992).

¹²⁵ See 11 U.S.C. § 362(a)(7).

¹²⁶ { TA \c 4 \s "Collier, ¶ 553.06[2] at 553-67 (citat" \l "*Collier on Bankruptcy*, ¶ 553.06[2], p. 553-67 (15th Ed. Rev.)" \l "*Collier on Bankruptcy*, ¶

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The determination as to whether a right of setoff exists lies within the discretion of the Bankruptcy Court, to be exercised in accordance with the general principles of equity.¹²⁷ While the allowance of setoffs is within the discretion of the Bankruptcy Court, a presumption exists in favor of setoffs, unless the setoffs in question would prejudice any third party.¹²⁸

To limit or avoid the risk of prejudice to third parties, bankruptcy law imposes certain restrictions on setoff rights. In order to qualify for a setoff under the Bankruptcy Code, the debts must be: (a) prepetition on both sides; and (b) mutual.¹²⁹ Mutuality requires that the debts be incurred "in the same right and between the same parties, standing in the same capacity."¹³⁰

The debtor's right to turnover of property of the estate in bankruptcy is expressly made subject to the non-debtor party's right to setoff under section 553 of the Bankruptcy Code.¹³¹ Section 553(a) permits a creditor of the debtor, with court approval, to offset a mutual debt owing to the debtor that arose prior to the commencement of the case. Thus, in circumstances where state

law does not impose or recognize a trust in contract proceeds for unpaid subcontractors and suppliers,¹³² setoff may be available to an owner who has either paid subcontractors and suppliers directly to avoid mechanics' and materialmen's liens, or who holds unpaid contract sums and faces the prospect of lien filings if the claims are not satisfied.¹³³

The Sixth Circuit case *Fulghum Construction Company*¹³⁴ is one of the leading cases addressing an owner's right to setoff unpaid contract proceeds.¹³⁵ In *Fulghum*, the debtor, a general contractor, contracted to perform construction for a transmission company. Under the terms of the contract, the contractor assumed responsibility for paying any incurred expenses to the subcontractor it employed, while the owner was to retain a percentage of payments pending the debtor's complete performance.¹³⁶ The owner learned that the contractor had not been paying its subcontractors and that some mechanics liens had been filed on the property and thereafter requested that subcontractors submit invoices directly to the owner.¹³⁷ Once the owner learned that the contractor had filed bankruptcy, the owner proceeded to pay the subcontractors from the retained funds.¹³⁸ When the trustee thereafter sought to recover the remaining unpaid amounts under the contract, the owner argued that it was entitled to setoff the amount paid to subcontractors against its debt to the estate.¹³⁹

553.06[2] at 553-67 (citation omitted); see { TA \s "In re Corland Corp."}Corland, 967 F.2d at 1076.

¹²⁷ { TA \c 1 \s "In re Fulghum" \l "In re Fulghum Construction Co., 740 F.2d 967 (6th Cir. 1984); 1984 U.S. App. LEXIS 14159 (6th Cir. 1984) (unpublished table decision)}In re Fulghum Construction Co., 740 F.2d 967 (6th Cir. 1984); { TA \c 1 \s "In re Potts" \l "In re Potts, 142 F.2d 883 (6th Cir. 1944), cert. denied, 324 U.S. 868 (1945)}In re Potts, 142 F.2d 883, 887 (6th Cir. 1944), cert. denied, 324 U.S. 868 (1945); accord, { TA \c 1 \s "Gilbert v. First Nat'l Bk" \l "Gilbert v. First National Bank, 633 F.2d 686 (5th Cir. 1980), cert. denied, 454 U.S. 825 (1981)}Gilbert v. First National Bank, 633 F.2d 686 (5th Cir. 1980), cert. denied, 454 U.S. 825 (1981).

¹²⁸ See, e.g., *In re Larbar Corp.*, 177 F.3d 439, 447 (6th Cir. 1999).

¹²⁹ See *Darr v. Muratore*, 8 F.3d 854, 860 (1st Cir. 1993); see also *In re Ionosphere Clubs, Inc.*, 164 B.R. 839, 843 (Bankr. S.D.N.Y. 1994).

¹³⁰ { TA \s "In re Larbar Corp."}Larbar Corp., 177 F.3d at 445.

¹³¹ { TA \s "Ponoroff, Construction Claims in Bankruptcy"}Ponoroff, at 388.

¹³² See, e.g., *United States v. Penden Iron & Steel Co.*, supra n. 103.

¹³³ { TA \s "Ponoroff, Construction Claims in Bankruptcy"}Ponoroff, at 388-89.

¹³⁴ { TA \s "In re Fulghum"}740 F.2d 967; 1984 U.S. App. LEXIS 14159 (6th Cir. 1984) (unpublished table decision).

¹³⁵ { TA \s "Ponoroff, Construction Claims in Bankruptcy"}Ponoroff, at 389.

¹³⁶ { TA \s "In re Fulghum"}Fulghum, at *2. (Page numbers denoted with a "*" refer to Lexis pagination.).

¹³⁷ { TA \s "In re Fulghum"}Fulghum, at *2-3.

¹³⁸ { TA \s "In re Fulghum"}Fulghum, at *3.

¹³⁹ { TA \s "In re Fulghum"}Fulghum, at *3.

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The trustee argued that there could be no setoff because there was no mutuality nor privity of contract between the owner and the payees.¹⁴⁰ The Sixth Circuit disagreed, however, explaining that:

"Privity of contract is not a requirement of the doctrine of mutuality. Mutuality in this case arises from the contracts between [the owner] and [the contractor] which entitled the owner, in the event of the contractor's default, to avoid the liens on its property by payment of the contractor's debts to the subcontractors. Pursuant to the contracts, the contractor became obligated to the owner to the extent that the latter satisfied the subcontractor's invoices. The retainage provisions of the contracts effectuated the contractor's obligation by allowing the owner to reduce its obligation to the contractor under the contract. This is a classic offset situation and is precisely the situation for which section 553 was designed."¹⁴¹

Thus, the Bankruptcy Court held, and the Sixth Circuit agreed, that based on the language of the contract documents, the owner had a pre-petition claim against the debtor for the debtor's failure to pay subcontractors and suppliers, for the removal of liens against the owner's property and for breach of contract.¹⁴²

The trustee next argued that mutuality was lacking inasmuch as the owner's payment to the subcontractors occurred after the filing of the petition.¹⁴³ In other words, the trustee argued that debts owed as a result of claims against the debtor prior to bankruptcy cannot be offset by claims arising against the estate after the petition is filed, because the prebankrupt debtor is legally distinct from the post-petition estate.¹⁴⁴ The Court stated that the trustee "missed the point" by looking to

the time of payment rather than the status of the mutual debts and credits as of the petition date.¹⁴⁵

The trustee also argued that the Bankruptcy Court abused its discretion in allowing the owner to setoff because, in paying out the claims, the owner had violated the automatic stay provisions of the Bankruptcy Code.¹⁴⁶ The Court noted that the owner's right to setoff was stayed by operation of section 362 and that, after having made the payments, the owner was nevertheless subject to the Bankruptcy Court's discretion to grant a setoff, which could only be effected by an order of the court.¹⁴⁷

While the Bankruptcy Court determined that the owner's payment of the subcontractor invoices was a violation of the stay, the Court concluded that such payment did not damage the estate: "Quite the contrary, the payments ... minimized the damages caused by [the debtor's] breach of its contracts and have benefitted the estate by reducing claims against [the debtor]."¹⁴⁸ Because the owner acted in good faith and its actions did not injure the debtor's estate, the Sixth Circuit held that it was not an abuse of discretion by the Bankruptcy Court to grant the owner a setoff of the invoices it honored.¹⁴⁹ Having shown that each of the elements for setoff under section 553 had been established, therefore, the Court affirmed the judgment of the District Court approving the setoff in favor of the owner.

Other decisions have also suggested that an owner should have the right to setoff retained contract proceeds anytime the contractor exposes the owner's property to lien claims of its subcontractors.¹⁵⁰

¹⁴⁰ { TA \s "In re Fulghum"}Fulghum, at *6.

¹⁴¹ { TA \s "In re Fulghum"}Fulghum, at *7.

¹⁴² { TA \s "In re Fulghum"}Fulghum, at *7.

¹⁴³ { TA \s "In re Fulghum"}Fulghum, at *7.

¹⁴⁴ { TA \s "In re Fulghum"}Fulghum, at *8.

¹⁴⁵ { TA \s "In re Fulghum"}Fulghum, at *8.

¹⁴⁶ { TA \s "In re Fulghum"}Fulghum, at *9.

¹⁴⁷ { TA \s "In re Fulghum"}Fulghum, at *13.

¹⁴⁸ { TA \s "In re Fulghum"}Fulghum, at *13.

¹⁴⁹ { TA \s "In re Fulghum"}Fulghum, at *13.

¹⁵⁰ See, e.g., *Stoehner v. Horizon Fabricators, Inc.*, 153 B.R. 840, 852 (D. Minn. 1993) (setoff would be valid where a debtor of the bankrupt pays a claim owing to one of the bankrupt's creditors, such as a mechanic's lien claimant); *Middleton & Dugger*

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In *In re Davidson Lumber Sales, Inc.*¹⁵¹ the Tenth Circuit provided a comprehensive analysis of the various issues involved in construction contracts. In *Lumber Sales*, a contractor made payment directly to a materials supplier of one of its subcontractors who was in chapter 11. Christiansen, the contractor, paid the supplier on behalf of the debtor because it was contractually obligated to keep the owner's property free and clear of liens. Zions First National Bank ("Zions") held a perfected security interest in the accounts receivable of the debtor and sought to enforce that interest out of the accounts receivable Christiansen allegedly owed the debtor.¹⁵² The Bankruptcy Court granted summary judgment to Christiansen, ruling that Christiansen owed the debtor nothing by virtue of Christiansen's payment of debts that the debtor owed to certain of its suppliers.¹⁵³ Zions appealed and the District Court reversed, holding that Christiansen's payment of the debtor's debts did not relieve Christiansen of its obligation to pay the debtor.¹⁵⁴ The Tenth Circuit reversed the judgment of the District Court.

In reversing the District Court, the Court focused on Utah law regarding setoff rights and noted that Utah recognized the principle of setoff.¹⁵⁵ The Court also noted that in order to achieve the protective purposes of Utah's mechanics liens statutes, the Utah courts construe such statutes broadly.¹⁵⁶ Accordingly, "in keeping

with the concern of the Utah courts and legislature that lienholders recover payment for material they have supplied" the Court concluded that "Utah would permit a general contractor who pays a supplier in order to prevent or to discharge a lien to set that payment off against amounts it owes to the defaulting subcontractor."¹⁵⁷

The bank argued that even if Christensen had a right to setoff, that right was subordinate to the bank's perfected security interest in the debtor's accounts receivable.¹⁵⁸ The Court, however, disagreed, explaining that section 9-104(i) of the Utah version of the Uniform Commercial Code ("UCC") states that Article 9 does not apply to any right of setoff.¹⁵⁹ Moreover, the Court explained that the relative rights of account debtors and assignees of accounts receivable are set out in section 9-318 of Utah's version of the UCC. Under that section, the bank, as assignee, is subject to "any ... defense or claim of the account debtor [Christensen] against the assignor [the debtor] which accrues before the account debtor receives notification of the assignment."¹⁶⁰

Texas common law also recognizes a right to offset.¹⁶¹ Moreover, Texas statutory law

Plumbing & Heating v. Richardson Builders, Inc. (*In re Richardson Builders, Inc.*), 123 B.R. 736, 740 (Bankr. W.D. Wa. 1990) (arguing that a policy reason for not permitting subcontractor to enforce its lien against non-debtor owner free of the stay is that owner will subsequently want to setoff any amounts paid to satisfy lien against its debt to general contractor, thus potentially prejudicing estate which will not have an opportunity to raise contract defenses it may have against subcontractor).

¹⁵¹ { TA \s "In re Davidson Lumber"}66 F.3d 1560 (10th Cir. 1995).

¹⁵² { TA \s "In re Davidson Lumber"}*Id.* at 1563.

¹⁵³ { TA \s "In re Davidson Lumber"}*Id.*

¹⁵⁴ { TA \s "In re Davidson Lumber"}*Id.*

¹⁵⁵ { TA \s "In re Davidson Lumber"}*Id.* at 1564.

¹⁵⁶ { TA \s "In re Davidson Lumber"}*Id.*

¹⁵⁷ { TA \s "In re Davidson Lumber"}*Id.* at 1564-65.

¹⁵⁸ { TA \s "In re Davidson Lumber"}*Id.* at 1565.

¹⁵⁹ { TA \s "Utah UCC Article 9"}*Id.* Texas has a similar provision, { TA \c 3 \s "Tex. UCC 9-104(9)" \l "TEX. BUS. & COM. CODE ANN. § 9-104(9)"}§ 9-104(9), which excludes "any right of setoff" from { TA \s "Utah UCC Article 9"}Article 9.

¹⁶⁰ { TA \c 3 \s "Utah UCC 70A-9-318(1)(b)" \l "UTAH CODE ANN. 70A-9-318(1)(b)"}{ TA \s "In re Davidson Lumber"}*Davidson Lumber*, 66 F.3d at 1565.

¹⁶¹ { TA \c 1 \s "Atkinson v. Jackson Bros." \l "Atkinson v. Jackson Bros., 270 S.W. 848 (Tex. Comm'n App. 1925, holding approved)"}*Atkinson v. Jackson Bros.*, 270 S.W. 848, 850 (Tex. Comm'n App. 1925, holding approved). Texas Law also requires the contractor to prove the amount of the offset and failing to prove the amount of the offset is fatal to a contractor's attempt to recover on the contract. See { TA \c 1 \s "Vance v. My Apartment" \l "Vance v. My Apartment Steak House of San Antonio, Inc., 677 S.W.2d 480 (Tex. 1984)"}*Vance v. My Apartment Steak House of San Antonio, Inc.*, 677 S.W.2d 480, 482 (Tex. 1984) (*reaffirming* { TA

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explicitly recognizes a right to offset against funds to be paid pursuant to a construction contract.¹⁶²

1. Other Cases of Interest

*Selby v. Ford Motor Co.*¹⁶³ The court in *Selby* discussed at length the special problems that arise with respect to payment down the line in the construction industry. The court pointed out that the Michigan trust fund statute at issue there was:

designed to remedy problems in the construction industry. Like the law merchant of an earlier day, the building trades have gradually created a set of commercial expectations as the result of the customs and practices of the industry. The nature of the industry is such that the commercial expectations of the parties are defeated when a building contractor or subcontractor does not use accounts paid to him on a job to pay subcontractors or materialmen. Unless the parties see that construction funds are properly applied down the line, the liabilities of the parties up the line are affected. The unpaid workers must undertake the lengthy and wasteful process of filing, perfecting and foreclosing on their mechanics liens. The owner's property and the construction lender's security are encumbered.¹⁶⁴

The court observed that to preserve the economic viability of the multi-tier payment system used in the construction industry,

courts and legislatures have increasingly found that the parties have an independent legal duty arising from reasonable commercial expectations to see to the proper application of construction funds. In the absence of statute, courts have declared that construction funds in the hands of a contractor are held subject to a constructive trust or an equitable assignment or an equitable lien. Even in the absence of a state builders trust statute, federal bankruptcy courts in a variety of situations have refused to apply the property, preference and statutory liens sections of the Bankruptcy Act to favor unsecured creditors over the equitable claims of subcontractors and materialmen to the proceeds of a construction project in the hands of a bankrupt contractor.¹⁶⁵

Bel Marin Driwall, Inc. v. Grover (In re *Bel Marin Driwall, Inc.*)¹⁶⁶ In this case the court was required to determine "whether direct payments by the bankrupt's debtor (a general contractor) to the bankrupt's creditor (a supplier to the bankrupt), made under obligation of California law, were invalid as setoffs" under the prior Bankruptcy Act. Under the California law applicable at the time, "a general contractor and his surety were subject to judgment in favor of unpaid materialmen and suppliers."¹⁶⁷ The court pointed out that the general contractor thus paid the suppliers pursuant to a mandatory obligation imposed by statute which existed independently of any duty which the bankrupt subcontractor owed to those suppliers to pay for materials furnished to

¹⁶² \s "*Atkinson v. Jackson Bros.*"*Atkinson v. Jackson Bros.*, 270 S.W. 848, 850 (Tex. Comm'n App. 1925, holding approved)), which held that the contractor has the burden to prove the cost to remedy the defects rather than the owner who actually remedied the defects).

¹⁶² See TEX. PROP. CODE § 162.031(B).

¹⁶³ { TA \s "*Selby v. Ford Motor Co.*"}590 F.2d 642 (6th Cir. 1979).

¹⁶⁴ { TA \s "*Selby v. Ford Motor Co.*"}*Id.* at 647.

¹⁶⁵ { TA \s "*Selby v. Ford Motor Co.*"}*Id.* at 648 (footnotes omitted).

¹⁶⁶ { TA \s "*Bel Marin Driwall v. Grover*"}470 F.2d 932, 933 (9th Cir. 1972).

¹⁶⁷ { TA \s "*Bel Marin Driwall v. Grover*"}*Id.* at 935.

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him.¹⁶⁸ The court held that when payment is made pursuant to such an independent legal obligation, setoff is proper.¹⁶⁹

Scherer Hardware & Supply, Inc. v. Charles H. Eichelkraut & Son, Inc. (In re Scherer Hardware & Supply, Inc.).¹⁷⁰ The court in Scherer Hardware addressed whether a general contractor who pays a bankrupt subcontractor's supplier pursuant to an independent legal duty may set this payment off against the debt owed to the subcontractor. The court recognized that according to the holding in *Bel Marin*, discussed above, "where a debtor of the bankrupt paid a claim of one of the bankrupt's creditors, a setoff should be allowed if the claim had been acquired as the result of a direct or independent legal obligation."¹⁷¹ The court indicated that there were two potential sources for a "direct legal obligation": "from the threat of a mechanics lien encumbrance of the real estate or from a direct legal obligation of the general contractor, whether contractual or statutory, to pay all claims of labor and materials."¹⁷² Unlike the supplier in *Bel Marin*, however, the supplier in *Scherer Hardware* had not properly perfected mechanics' and materialmen's liens against the owner or prime contractor.¹⁷³ The court found this fact determinative, and stated, "the setoff should not be allowed if the payment had been made voluntarily and without compulsion."¹⁷⁴ Since the supplier had failed to properly perfect a mechanic's and materialman's lien and was not in privity of contract with the prime contractor, the general contractor had no "direct legal obligation" and as a result, could not use the supplier's claim as a predicate for setoff. Thus his only recovery would

be as a general unsecured creditor of the debtor's estate.¹⁷⁵

Subsequent cases have similarly held in the bankruptcy context that where a general contractor pays suppliers pursuant to an independent legal obligation imposed either by statute or by contract, the general contractor may set that debt off against amounts owing to the subcontractor.¹⁷⁶

At least two courts have held that when a subcontractor is obligated by a contract with the general contractor to supply materials and fails to pay his suppliers, he has breached his contract and the general contractor is no longer contractually obligated to pay the defaulting subcontractor.¹⁷⁷ Under these holdings, the subcontractor has no legal or equitable interest in funds held by the general contractor.¹⁷⁸ Accordingly, such funds are not part of the bankruptcy estate and the security interest of the subcontractor's creditor cannot attach to them.¹⁷⁹

D. AN OWNER'S SETOFF RIGHTS VS. THE RIGHTS OF AN ASSIGNEE

An owner's setoff rights are senior to the rights of any entity to whom such owner's receivables may have been assigned, whether through an outright sale or otherwise. In *In re Alliance Health of Fort Worth, Inc.*¹⁸⁰ the primary issue was whether the Bankruptcy Court erred in holding that the rights of *Cherry Street*, the

¹⁶⁸ { TA \s "Bel Marin Driwall v. Grover"}*Id.*

¹⁶⁹ { TA \s "Bel Marin Driwall v. Grover"}*Id.* at 935-36.

¹⁷⁰ { TA \s "Scherer v. Eichel"}9 B.R. 125 (Bankr. N.D. Ill. 1981).

¹⁷¹ { TA \s "Scherer v. Eichel"}*In re Scherer*, 9 B.R. at 129.

¹⁷² { TA \s "Scherer v. Eichel"}*Id.* at 129.

¹⁷³ { TA \s "Scherer v. Eichel"}*Id.* at 127-28.

¹⁷⁴ { TA \s "Scherer v. Eichel"}*Id.* at 129.

¹⁷⁵ { TA \s "Scherer v. Eichel"}*Id.* at 133.

¹⁷⁶ See, e.g., *Stoehner v. Horizon Fabricators, Inc.*, 153 B.R. 840 (D. Minn.); *In re E. & D. Elec. Co., Inc.*, 68 B.R. 3 (Bankr. S.D. Miss. 1986); *In re Flanagan Bros., Inc.*, 47 B.R. 299 (Bankr. D. N.J. 1985).

¹⁷⁷ See *Tri-City Serv. Dist. v. Pacific Marine Dredging & Constr. (In re Pacific Marine Dredging & Constr.)*, 79 B.R. 924, 929 (Bankr. D. Or. 1987); *Business Fin. Servs. v. Butler & Booth Dev. Co.*, 147 Ariz. 510, 711 P.2d 649, 651-52 (Ariz. Ct. App. 1985).

¹⁷⁸ See *In re Pacific Marine*, 79 B.R. at 929.

¹⁷⁹ { TA \s "Scherer v. Eichel"}*Id.*

¹⁸⁰ { TA \s "In re Alliance Health"}240 B.R. 699 (N.D. Tex.) *aff'd without published opinion*, 200 F.3d 816 (5th Cir. 1999).

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*purported secured creditor, were superior to the rights of the IRS to set off the debt owed to the debtor against the taxes due by the debtor.*¹⁸¹ *The court narrowed the issue to a "very simple question":*

Since when does an assignee of a claim wind up with more than the assignor would be entitled to had he not assigned the claim?" *Defense Servs., Inc. v. United States (In re Defense Servs., Inc.)*, 104 B.R. 481, 484 (Bankr. S.D. Fla. 1989). *And, the answer is, of course, that a valid and unqualified assignment operates to transfer to the assignee no greater right or interest than was possessed by the assignor. Id.* at 485 (emphasis added). In other words, there is no question that setoff would have been appropriate had debtor not filed bankruptcy. The fact that debtor assigned its rights has no effect on the set-off right. Neither does the fact that debtor filed bankruptcy. 11 U.S.C. § 553.¹⁸²

The court went on to explain that even where state law to be applied in determining whether appellant may exercise the right to setoff, the result would be the same:

Although the right to set-off is not an Article 9 security interest, § 9.318 determines the priority between a right of set-off and a security interest. *In re Otha C. Jean & Assocs., Inc.*, 152 B.R. 219, 222 (Bankr. E.D. Tenn. 1993). *It provides that the right to set-off (a defense to payment) prevails over a perfected security interest unless the account debtor, appellant, had actual notice of the security interest before the set-off*

right accrued. Id. And, mere filing of a UCC financing statement is not notice for purposes of § 9.318. *Zions First Nat'l Bank, N.A. v. Christiansen Bros., Inc. (In re Davidson Lumber Sales, Inc.)*, 66 F.3d 1560, 1565-66 (10th Cir. 1995); *In re Otha C. Jean & Assocs., Inc.*, 152 B.R. at 222-23. Moreover, the burden is on the secured creditor to establish that the account debtor received notice. *Davidson*, 66 F.3d at 1565. Here, there has been no suggestion, much less any evidence, of notice having been given at any time.

E. RECOUPMENT

Several courts have held that the equitable doctrine of recoupment, as distinguished from the right of setoff, may be exercised by a creditor to withhold payments due the estate without regard to the requirements which apply to setoffs, including the requirements imposed by section 362(a) of the Code.¹⁸³ Recoupment is an equitable doctrine designed to "determine a just liability on the plaintiff's claim."¹⁸⁴ Recoupment is not expressly regulated by the Bankruptcy Code.¹⁸⁵ The doctrine is justified on the grounds that "where the creditor's claim against the debtor arises from the same transaction as the debtor's claim, it is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation, and application of the limitations on setoff in bankruptcy would be inequitable."¹⁸⁶

¹⁸¹ { TA \s "In re Alliance Health"}*Id.* at 704.

¹⁸² { TA \s "In re Alliance Health"}*Alliance Health*, 240 B.R. at 704.

¹⁸³ { TA \s "Ponoroff, Construction Claims in Bankruptcy"}*Ponoroff*, at 392.

¹⁸⁴ { TA \c 1 \s "In re Holford" \l "In re Holford, 896 F.2d 176 (5th Cir. 1990)"}*In re Holford*, 896 F.2d 176, 179 (5th Cir. 1990), quoting { TA \c 1 \s "In re Clowards, Inc." \l "In re Clowards, Inc., 42 B.R. 627 (Bankr. D. Idaho 1984)"}*In re Clowards, Inc.*, 42 B.R. 627, 628 (Bankr. D. Idaho 1984).

¹⁸⁵ { TA \c 1 \s "Newberry v. Citibank" \l "Newberry Electric, Inc. v. Citibank (Arizona), 95 F.3d 1392 (9th Cir. 1996)"}*Newberry Electric, Inc. v. Citibank (Arizona)*, 95 F.3d 1392, 1399 (9th Cir. 1996).

¹⁸⁶ { TA \c 1 \s "In re University Med. Ctr." \l "In re University Medical Center, 973 F.2d 1065 (3rd Cir. 1992)"}*In re University Medical Center*, 973 F.2d

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Recoupment is based on the premise that "the defendant should be entitled to show that because of matters arising out of the transaction sued on, he or she is not liable in full for the plaintiff's claim."¹⁸⁷

F. CASH COLLATERAL

The issue of cash collateral generally arises in the context of larger chapter 11 bankruptcy cases in which a bank or other financing party has a secured claim on the funds of the debtor. If a mechanic's lien has been filed by a subcontractor of the debtor-contractor, for example, and the debtor-contractor owes money to the subcontractor, a question arises as to whether the money owed the subcontractor claiming a lien is, in fact, cash collateral of the bank, entitling such bank to adequate protection on its secured claim.

Pursuant to the Texas Trust Fund statute, any funds borrowed by an owner, contractor or subcontractor, in connection with a specific real estate project, and all funds paid to a contractor or a subcontractor, constitute "trust funds" by statute.¹⁸⁸ Accordingly, it would appear that these trust funds do not, in fact, constitute cash collateral of the bank; rather, it seems these funds should be held in trust for the benefit of unpaid laborers and subcontractors. However, section 162.004 exempts from trust fund liability banks, savings and loans and other lenders, as well as title companies, other closing agents and corporate sureties issuing bonds.¹⁸⁹

G. AVOIDANCE ACTIONS

1065, 1080 (3rd Cir. 1992), quoting { TA \c 1 \s "Lee v. Schweiker" \l "Lee v. Schweiker, 739 F.2d 870 (3rd Cir. 1984)" \l "Lee v. Schweiker, 739 F.2d 870, 875 (3rd Cir. 1984).}

¹⁸⁷ { TA \s "Newberry v. Citibank" \l "Newberry Electric, 95 F.3d at 1401.}

¹⁸⁸ { TA \s "TPC 162.001" \l "§ 162.001 et seq.}

¹⁸⁹ { TA \s "TPC 162.004" \l "§ 162.004. For an interesting interpretation of the prior version of this statute, see { TA \c 1 \s "Republicbank Dallas v. Interkal" \l "Republicbank Dallas v. Interkal, Inc., 691 S.W.2d 605 (Tex. 1985)" \l "Republicbank Dallas v. Interkal, Inc., 691 S.W.2d 605 (Tex. 1985).}

A preference is any transfer of a debtor's property within a prescribed period of time while the debtor is insolvent if its effect is to enable one creditor to obtain a greater percentage of his debt than other creditors of the same class.¹⁹⁰ The essence of a preference is that it depletes or diminishes the property of the estate that is available for distribution to the other creditors. The basic goal of the Code with respect to preferences is to secure equal distribution of the debtor's assets among all of his creditors,¹⁹¹ and to prevent favoritism. The preference provision is also intended to discourage creditors from racing to the courthouse to dismember the debtor during his slide into bankruptcy.¹⁹²

A transfer of property does not constitute a preference, however, unless the transfer enables a creditor to receive more than such creditor would receive if the case were a chapter 7 case, the transfer had not been made, and the creditor received payment of such debt to the extent provided by the provisions of Title 11.¹⁹³

Sections 547(c)(6) and 545 essentially provide that the trustee cannot avoid as a preferential transfer the perfection within the preference period of a true statutory lien.¹⁹⁴ By

¹⁹⁰ { TA \c 1 \s "Kenan v. Fort Worth Pipe" \l "Kenan v. Fort Worth Pipe Co. (In re George Rodman, Inc.), 792 F.2d 125 (10th Cir. 1986)" \l "Kenan v. Fort Worth Pipe Co. (In re George Rodman, Inc.), 792 F.2d 125 (10th Cir. 1986).}

¹⁹¹ { TA \c 1 \s "Yellowhouse v. Mack" \l "Yellowhouse Machinery Co. v. Mack (In re Hughes), 704 F.2d 820 (5th Cir. 1983)" \l "Yellowhouse Machinery Co. v. Mack (In re Hughes), 704 F.2d 820 (5th Cir. 1983).}

¹⁹² { TA \c 1 \s "Danning v. Bozek" \l "Danning v. Bozek (In re Bullion Reserve of North America), 826 F.2d 1214 (9th Cir.), cert. denied 486 U.S. 1056, 108 S.Ct. 2825, 100 L. Ed 2d 925 (1988)" \l "Danning v. Bozek (In re Bullion Reserve of North America), 826 F.2d 1214 (9th Cir.), cert. denied 486 U.S. 1056, 108 S.Ct. 2825, 100 L. Ed 2d 925 (1988).}

¹⁹³ { TA \c 2 \s "11 U.S.C. 547(b)(5)" \l "11 U.S.C. § 547(b)(5)" \l "11 U.S.C. § 547(b)(5).}

¹⁹⁴ { TA \c 1 \s "In re Johnson" \l "In re Johnson, 25 B.R. 889 (Bankr. E.D.Tenn. 1982)" \l "In re Johnson, 25 B.R. 889, 893 (Bankr. E.D.Tenn. 1982).}

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creating an exception to the preference section for the fixing of valid statutory liens, section 547(c)(6) provides protection for mechanics' liens.

The Bankruptcy Code defines a statutory lien as follows:

"statutory lien" means lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include security interest or judicial lien, whether or not such interest of lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute.¹⁹⁵

The legislative history to section 101(53) lists mechanics', materialmen's, and warehousemen's liens as examples of statutory liens. Additionally, a number of courts have observed that mechanics' liens are statutory liens because they arise strictly by operation of statute and not by agreement between the parties or judicial action.¹⁹⁶

Although the language of section 547(c)(6) arguably applies only to the fixing of a lien, the legislative history reflects Congress' intent that section 547(c)(6) also exempts from the trustee's avoiding power "transfer in satisfaction of such liens."¹⁹⁷ However, there is not an exception under section 547(c) which specifically excludes the avoidance of transfers in satisfaction of a lien.¹⁹⁸ Nevertheless, the holder of a statutory lien

that is not avoidable under section 545 will typically hold a secured claim so that payment in satisfaction of such a claim will not have a preferential effect under section 547(b)(5).¹⁹⁹

VII. CONCLUSION

The possibility of increased construction-related bankruptcies, whether in the short or long term, is likely. Construction law issues, because they are unusual for bankruptcy practitioners, factually intensive and often result in zero sum outcomes, can be particularly troublesome. The special statutory protections offered suppliers and contractors serve to increase the number of issues and problems likely to be encountered. The added complexities of the Bankruptcy Code to the construction arena only enhances the likelihood of making a costly or time-consuming error in achieving your clients' desired objectives. This article, while not an exhaustive treatise on the issues, highlights some of the more typical and recurring problems that are or have been encountered. In the end, a careful assessment of the parties' competing interests, rights and claims, combined with a well reasoned and principled approach to the issue, should allow the practitioner to avoid, or at least navigate, these problems.

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¹⁹⁵ { TA \s "11 U.S.C. 101(53)"}11 U.S.C. § 101(53).

¹⁹⁶ { TA \c 1 \s "Klein v. Civale & Trovato" \l "Klein v. Civale & Trovato (In re Lionel Corp.), 29 F.3d 88 (2nd Cir. 1994)"}Klein v. Civale & Trovato (In re Lionel Corp.), 29 F.3d 88, 94 (2nd Cir. 1994), and cases cited therein.

¹⁹⁷ { TA \c 1 \s "Cimmaron v. Cameron" \l "Cimmaron Oil Company v. Cameron Consultants, 71 B.R. 1005 (Bankr. N.D. Tex. 1987)"}Cimmaron Oil Company v. Cameron Consultants, 71 B.R. 1005 (Bankr. N.D. Tex. 1987).

¹⁹⁸ See *Daniel v. U.S. Dept. of Treasury (In re R & T Roofing Structures)*, 42 B.R. 908 (Bankr. D. Nev. 1984), *aff'd* 79 B.R. 22 (D. Nev. 1987).

¹⁹⁹ { TA \c 4 \s "Collier ¶ 547.04[6] (15th Ed. Rev.)" \l "Collier on Bankruptcy ¶ 547.04[6] (15th Ed. Rev.)"}Collier on Bankruptcy ¶ 547.04[6] (15th Ed. rev.).