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Understanding Payment Disputes in Bankruptcy Between Project Participants During and After Completion of Construction Projects

By James P. Chivilo, Richard A. Bixter and Gregory R. Meeder*

In this article, the authors discuss often-overlooked strategies that project participants can use to address preference demands.

Due to the prohibition on seeking payment from a debtor in bankruptcy—called the automatic stay—a bankruptcy filing by a single construction project participant can cause a chain reaction, leading to financial distress, impacts to project payment systems, project completion schedules and/or bankruptcy for other participants.

To add insult to injury, the bankrupt company ("Debtor") or a court-appointed trustee ("Trustee") has the ability to demand the return or "clawback" of all payments made by the Debtor to third parties in a 90-day period prior to the date the Debtor's bankruptcy case began. These are often referred to as "preference demands."

Non-bankruptcy project participants can be understandably upset when they learn about this aspect of bankruptcy law. The bankruptcy filing of a construction project participant will likely lead to payment stoppages and project disruptions, and on top of that, a Trustee can seek to clawback partial payments received by other contractors, subcontractors or suppliers from the Debtor. These demands often take the form of the letter from the Debtor's or Trustee's attorney (sometimes years after the bankruptcy was filed) and can be followed by a lawsuit filed in the bankruptcy court if the payment demand is not resolved in the Debtor's bankruptcy case.

The good news is that non-bankrupt project participants have several defenses that may reduce or completely eliminate liability in connection with

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preference demands. Many of these defenses are available to all payment recipients, and there are particular defenses that specifically apply to project participants given the unique contractual relationships among these parties.

This article discusses often-overlooked strategies that project participants can use to address preference demands.

PREFERENCE CLAIMS

Preference claims are becoming a regular occurrence as Trustees hunt for funds available to pay creditors. The general rule is that a Trustee or Debtor may seek the return, or clawback, of funds paid by the Debtor to third parties in the 90 days prior to the Debtor's bankruptcy filing. This preference period is extended to one year if the payments were made to an "insider" such as a family member of the Debtor's owners or certain business affiliates.[1]

The policy behind this bankruptcy law is that a Debtor should not be permitted to "prefer" one creditor over its other creditors, and any amounts paid out immediately prior to bankruptcy should be brought back into the bankruptcy estate for a more even distribution among the Debtor's entire list of creditors.

The Bankruptcy Code recognizes that, in many cases, payments within the 90-day preference window, were not preferential in nature. However, there are various defenses that one can raise to a preference demand. Most common among these are the ordinary course of business defense (payments were made according to ordinary business terms and the historical practice of the parties), and the new value defense (e.g., after receiving the preference payment, the non-debtor provided new goods or services to the Debtor, offsetting the preference payment). However, these common defenses can be subjective in nature, and they rarely convince the Trustee to fully drop its preference demand.

The good news is that there are unique defenses available to non-debtor project participants which, in certain circumstances, may result in an objective defense that no liability exists in connection with a preference demand. For example, the non-debtor participant may be the holder of a statutory lien right in association with its contractual project obligation to provide labor, materials or services as it relates to the Debtor contractor, as well as the non-debtor's right to receive payment.

In this instance, the non-debtor may fall under the umbrella of a statutory lienholder, and will be recognized by the bankruptcy court as a secured creditor

[1] *See* 11 U.S.C. § 547.

that is entitled to the full value of amounts due under the applicable construction contract and the amounts due to be paid prior to the bankruptcy filing or amounts, which were in fact paid during the 90-day preference period.

In such a situation, the Debtor's or Trustee's attempt to clawback the alleged preference payments is improper and inconsistent with mechanic's lien law and bankruptcy law principles, for the reasons set forth further below.[2]

ELEMENTS OF A PREFERENCE

Under the Bankruptcy Code, a Trustee can recover preferential transfers made from the debtor's estate if the transfer was:

(1) Made to a creditor;

(2) For a debt owed by the Debtor;

(3) Made while the Debtor was insolvent;

(4) Within 90 days prior to the Debtor's filing of its bankruptcy; and

(5) Enabled the creditor to receive more than it would have received in the Chapter 7 liquidation of the Debtor.

Most notable is the fifth element and its applicability to mechanic's lien holders. It is well-settled law that, in a Chapter 7 liquidation case, if a creditor is fully secured, it should receive the full value of its claim.[3]

SECURED STATUS AS A DEFENSE TO A PREFERENCE CLAIM

Construction-based creditors are typically secured creditors entitled to full payment under the applicable construction contract as a result of statutory mechanic's lien rights. Bankruptcy courts will incorporate non-bankruptcy property and lien law, and a properly perfected mechanic's lien will be recognized as valid under the Bankruptcy Code. Bankruptcy law is clear that the holder of a mechanic's lien is a secured creditor within the meaning of the Bankruptcy Code.[4] Illinois law identifies four requirements to acquire a mechanic's lien:

(1) A valid contract;

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[2] *See* 11 U.S.C. § 546(b)(1).

[3] *See Golfview Developmental Ctr., Inc. v. All-Tech Decorating Co.*, 309 B.R. 758, 768 (Bankr. N.D. Ill. 2004).

[4] *Golfview Developmental Ctr., Inc.*, 309 B.R. at 769; *see also In re FBI Wind Down, Inc.*, 581 B.R. 387, 405 (Bankr. D. Del. 2018) (to the extent that a claimant even holds an inchoate mechanic's lien, it is a secured creditor).

(2) The contract is with the owner or knowingly permitted by the owner;

(3) The claimant furnished services; and

(4) The claimant performed the services under the contract.[5]

As such, a fully secured creditor with a mechanic's lien will be entitled to full payment from its collateral prior to payment to any unsecured creditors. Under this circumstance, any pre-bankruptcy payment to a fully secured creditor cannot be a preference payment. Accordingly, the creditor will have a very strong argument that there is zero preference liability in connection with the pre-bankruptcy payments from the Debtor.

Alleged Preference Payments Consisted of Funds "Earmarked" for Transfer Down the Construction Project Chain

Even if the non-debtor participant does not hold a mechanic's lien and is not otherwise a secured creditor, there are other defenses that may apply in response to the preference demand given the unique relationship among construction project participants.

For example, there is the rarely employed "earmarking doctrine" in response to a preference demand. The earmarking doctrine applies in situations where:

(1) An agreement exists between the Debtor and a non-debtor (often the creditor that received the preference demand) for repayment of an antecedent debt;

(2) The performance was made on that agreement as a result of which the creditor receives payment;

(3) The Debtor lacked control over the funds used for payment to the creditor; and

(4) The payment does not deplete the funds available to the Debtor for its bankruptcy case.[6]

An earmarking scenario often arises given the nature of the construction project payment context. For example, the Debtor may be an intermediary in the construction project chain, and the funds transferred to the creditor may have ultimately came from the project owner or somewhere else upstream, with a contractual obligation for the Debtor to transfer the funds downstream to the contractors, subcontractors and or suppliers. In such situations, there is a strong

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[5] *Id.* at 768.

[6] *In re Network 90 degrees, Inc.*, 126 B.R. 990, 994 (Bankr. N.D. Ill. 1991) ("The foundation of the earmarking doctrine lies . . . in the debtor's control (or lack of control) over the assets which were transferred.").

defense that the earmarking doctrine applies, as these funds were earmarked for payment to downstream contractors, and were never Debtor's property to begin with and never under Debtor's ultimate control.[7]

Moreover, payment and receipt of these funds do not deplete the Debtor's estate, because an argument can be made that these funds were never truly assets of the Debtor and to the extent the non-debtor recipient has a mechanic's lien or other lien rights, the non-debtor was entitled to full payment of the amount due.[8]

The Contract Fund Payments Belong to the Creditor by Virtue of Lien Law Trust Fund Provisions

Under Illinois law, an owner who requires the execution and delivery of a waiver of mechanic's lien by any person who furnishes services in exchange for payment, shall hold in trust the sums due to the person who furnished the services.[9]

An established principal of bankruptcy is that debtors and creditors enter with the property rights they held prior to the bankruptcy filing. In the above scenario, a Debtor holding funds in trust for the creditor in exchange for a lien waiver does not have full equitable title to the trust fund, and thus these funds cannot comprise property of the bankruptcy estate available to be distributed to other creditors.[10]

In the preference context, when lien waivers are exchanged for payment prior to the bankruptcy filing, there is a presumption under Illinois law that those funds are subject to the trust provisions of mechanic's lien law. Given that these funds could never be available to a Trustee to pay a Debtor's creditors, there is no credible argument that the release of the funds held in trust was a preference payment that provided the non-debtor with a better result than it would have received in a Chapter 7 liquidation (i.e., the benefit of receiving funds to which

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[7] *In re Network 90 degrees, Inc.* establishes that the earmarking doctrine does not necessarily require the payment to come from a new creditor. *Id.* Thus, it is sufficient when owners or other downstream contractors issue payments directly to the targeted creditor of the preference demand.

[8] *See Golfview Developmental Ctr., Inc.*, 309 B.R. at 776 (noting that a fully secured creditor receiving payment would not negatively affect other creditors of the debtor's estate).

[9] *See* 770 ILCS 60/21.02.

[10] *See In re Raymond Professional Gr., Inc.*, 408 B.R. 711 (Bankr. N.D. Ill. 2009) *amended in part by In re Raymond Professional Gr., Inc.*, 410 B.R. 813 (Bankr. N.D. Ill. 2009) (holding that, pursuant to 770 ILCS 60/21.02, funds held in trust whose payment depended upon subcontractors issuing lien waivers to the owner and contractor (debtor) upon their request belonged to the subcontractor and were not the property of the debtor's bankruptcy estate).

it was not entitled to payment of under a contract agreement upstream due to payment obligations with its downstream contractors). Accordingly, where the "trust fund" defense may be applied, it will be a strong defense to a preference demand.

CONCLUSION

The bankruptcy filing by a construction project partner can be a disruptive event, particularly where the bankrupt company or a court-appointed Trustee seeks to clawback the funds through a preference demand. Upon receipt of a preference demand letter seeking return of all payments, a non-debtor must respond to preserve its rights, and when and where applicable utilize the particular rights and defenses that are specific to construction project participants.