CHAPTER 18

Bankruptcy Primer for Creditors

EXECUTIVE SUMMARY AND CONCLUSIONS

This outline is intended to introduce construction contractors, suppliers and other commercial creditors to some of the issues and concepts in bankruptcy law. This is not a comprehensive explanation of bankruptcy and will not deal at all with many issues. We have generalized and simplified many legal concepts, so that the explanations are short, uncluttered and easily understandable. Every set of facts and circumstances raises different legal issues. You should consult this firm or another attorney in dealing with any specific problem.

Prior to Bankruptcy

If you deal with bankruptcy cases regularly, you will come to the conclusion that a creditor avoids bankruptcy preference problems by using the same techniques good credit managers already use to avoid collection problems. Good preference defenses are just an extra-added bonus for good credit management. The creditor that consistently forced the debtor to stay on terms will have a smaller receivable to lose in bankruptcy and will also not have preference problems. By definition, all of these payments were in the ordinary course of business.

Similarly, the creditor that always preserved and enforced mechanic's lien and bond rights is more likely to collect after bankruptcy *and* will have better defenses against preference actions for monies received before bankruptcy. Mechanic's lien and bond rights are the single greatest mechanisms for construction suppliers to avoid bankruptcy problems. It is an opportunity to be a secured creditor, often with priority over all other secured creditors in the bankruptcy. If you still had mechanic's lien and bond rights at the time of pre-bankruptcy payments, you will also have much better defenses to any preference action.

If a creditor is concerned with insolvency, they can refuse to deliver on any project that does not have good payment bond or mechanic's lien rights. Payment bond rights are probably the best and most efficient mechanism to enforce payment. Mechanic's lien rights can vary in strength and can be expensive to enforce. The creditor must research the payment bond and mechanic's lien rights on any particular project before beginning deliveries.

Creditors requiring some type of consensual security will have the same dual benefits in a subsequent bankruptcy. With a security interest in accounts receivable or liens on equipment, there is a much lower chance of default. The debtor is more likely to stay within terms. The pre-petition unpaid receivable will be lower in the event of bankruptcy. Any payments received shortly before bankruptcy will not be preferences, because there was an enforceable security interest against the debtor.

By the same token, if a creditor has a personal guaranty, the debtor is more likely to stay on terms. The unpaid receivable will be lower. The payments received are more likely to be "in the ordinary course of business," because the invoices will not be as old. This creditor will also have a better chance of collecting an unpaid receivable after bankruptcy. The creditor is still free to sue the guarantor, unless the guarantor is also in bankruptcy.

Requiring COD shipments may be the surest way to avoid bankruptcy issues. You do not need to worry about collecting payment for materials, if you are collecting on delivery. These payments cannot be preferences. Even if the debtor gives you a bad check, you can probably object to a discharge from this debt because of fraud.

Joint check agreements and trust fund agreements are helpful mechanisms to collect receivables before and after bankruptcies. These mechanisms will also provide protections against preference claims.

If a creditor is genuinely concerned with insolvency, it is generally better to get payments from anyone other than the debtor.[1] Joint check agreements can be a good mechanism for this purpose.[2] Owners or bonding companies can agree to make direct payments to a creditor. This is the single best protection against preference problems. Even if a creditor has perfectly good mechanic's lien or bond rights, a bankruptcy estate is likely to bring a preference claim if

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[1] *See* subsection below on Preferences; sub-subsection Trustee's Burden of Proof; sub-sub-subsection, Earmarking.

[2] *Mid-Atlantic Supply, Inc. v. Three Rivers Aluminum Co.* (*In re Mid-Atlantic Supply Co.*), 790 F.2d 1121 (4th Cir. Va. 1986).

a payment is made directly from the debtor to the creditor during the preference period. If a creditor has made a bond claim or mechanic's lien claim, it is preferable to demand payment directly from the bonding company or owner.

Reclamation rights can be helpful pre-bankruptcy tools. A creditor concerned with bankruptcy can make a reclamation demand. Reclamation rights would survive bankruptcy. Those reclamation rights can then be traded for cash or security. This would not be a preference, since it is a contemporaneous exchange for new value. Even if the creditor fails to provide the written reclamation demand in time, the creditor is still entitled to an "administrative expense claim" for any goods received by the debtor in the 20 days prior to the bankruptcy petition. Filing for an administrative expense claim provides the creditor a high priority in the bankruptcy that will normally result in payment.

It is helpful to get new financial statements regularly, especially if there is concern over a bankruptcy. First, this will help the creditor investigate the risk of bankruptcy and determine whether they wish to continue doing business. If a debtor refuses to supply any financial information, this should only add to a creditor's concern.

If the debtor does supply incorrect financial information, this may constitute a written misrepresentation concerning solvency. This misrepresentation can extend the creditor's reclamation rights more than 10 days and may be grounds to avoid discharge in bankruptcy from this particular debt.

After Your Customer Files Bankruptcy

Once a customer files bankruptcy, quick action can help collect a receivable and avoid preference problems. A Bankruptcy Checklist is in the Appendices.

What You Can Do Now to Collect Accounts Receivables

On the outstanding accounts receivable, the most important thing to do now is establish security rights. This usually means mechanic's lien and payment bond claims. You are still free to make payment bond claims (as long as the bonding company is not in bankruptcy). This is true in all states.

In most states, the mechanic's lien is not a preference and does not violate the automatic stay. This means you are free to file mechanic's liens wherever you may have rights. In fact, you must still file your mechanic's liens within the normal deadlines, which could be as soon as 90 days after your last deliveries. This is true in Virginia and the District of Columbia. In Maryland and some other states, however, the mechanic's lien is not "inchoate." Consequently, you are stayed from proceeding against the property of the debtor in a mechanic's lien action.

In Maryland and many other states, it may be possible to establish rights under a "Trust Fund Statute" even after a bankruptcy. You may also have a trust fund agreement with your debtor that brings you to the same result. You may be able to collect a receivable directly from an owner or general contractor. You may even be able to establish priority over money held by the bankruptcy estate.

Reclamation rights can also trump a bankruptcy, as discussed below.

You have less risk accepting payments from someone other than the bankrupt debtor, both before and after a bankruptcy filing. Encourage bonding companies, property owners and general contractors to make payment directly to you. A joint check is also better than a direct payment from the debtor, although after bankruptcy the debtor's endorsement of the check may technically require bankruptcy court approval.

After bankruptcy, the debtor can "assume" contracts that are profitable and "reject" unprofitable contracts. Creditors on rejected contracts become general unsecured creditors. The debtor must "cure all default" on assumed contracts. If you have a contract to supply all of the materials at a favorable price on a profitable job, the debtor may wish to assume the contract to complete the job. You would have to continue supplying the job, but the debtor would also need to cure all default and pay your pre-petition invoices. The debtor may also wish to assume a profitable contract with a general contractor or owner. That contract may require the debtor to make sure all subcontractors and suppliers are paid on the project. Curing all default on that contract may require the debtor to pay invoices on that job.

If nothing else, you should be sure to file your proof of claim in the bankruptcy. This will ensure that you share in any future distributions to general unsecured creditors. The notice of bankruptcy you receive will give you instructions regarding proofs of claim. File a proof of claim early, even if no deadline has been set. This helps insure that you will not miss a deadline, if the court later sets one.

You can also check on the bankruptcy court website whether there is a deadline for proofs of claim. This bankruptcy court sponsored website includes much basic information regarding a case. You can also subscribe to a service

known as PACER (Public Access to Court Electronic Records), which allows you to access almost all papers filed in the case for a small fee. You can file a Rule 2002 Request for Service of Papers, requesting hard copies of all papers filed in the case. You or your attorney can also request a CM/ECF (Case Management/Electronic Case Filings) ID and password. You can then electronically file and monitor all papers filed in that bankruptcy case.

CM/ECF allows you 24-hour access to case file documents, to file electronically, to automatically receive email notice of all case activity, and to download and print all documents filed in the case directly from the court's system. You will receive notice of future events in the bankruptcy, including any deadline for proofs of claim. In a large bankruptcy, this also means a large volume of paper and electronic files that you do not care about. The safest course, however, is to have someone keep track of motions and other events in the bankruptcy, either on PACER or through a Rule 2002 Request for Service. Even if you include your email address on your Rule 2002 Request for Service, you will not receive email notification of case filings unless you also have a CM/ECF ID and Password. For more information on signing up with CM/ECF, go to: http://pacer.psc.uscourts.gov/cmecf/index.html.

Extending New Credit to the Debtor

The only truly safe way to do business with a debtor in bankruptcy is to require cash in advance. Otherwise, any creditor at least runs the risk of administrative costs and problems going to bankruptcy court to enforce payment. However, there are also risks of non-collection.

You will have a high administrative expense priority for post-petition sales, but there may be no money available for distribution no matter how high your priority. Another secured lender may have "super-priority" over all available cash flow. An administrative expense claim can also be denied if the expense was not "actual and necessary" for the preservation of the estate.

A creditor with an ongoing contract may be forced to continue doing business with the debtor. It is very risky, however, to continue performance and extend credit unless and until the contract is assumed. Otherwise, the creditor can have the same problems with an administrative expense claim just discussed. A creditor is better off requiring assumption of the contract, before continuing performance. This will also result in "cure" and payment of all pre-petition debt. If the debtor is unwilling or unable to assume the contract immediately, the creditor should insist on cash in advance, a letter of credit or other adequate assurance before continuing performance.

Evaluating Risk of Future Preference Claims

You are at risk for a preference claim for all payments you received in the 90 days prior to the bankruptcy. Unfortunately, the bankruptcy trustee does not need to bring a preference claim against you for two years. The "statute of limitations" for a preference claim is two years after the bankruptcy petition.

The bankruptcy trustee will get payment records from the debtor during the course of the bankruptcy. The trustee will probably make a preference claim on all payments made by the debtor in the 90 days prior to the bankruptcy that were on invoices that were more than 60 days old. The critical date is the day the debtor's check clears their bank, not the date you receive or deposit the check. The trustee generally will not spend much time evaluating whether each payment is a preference; they will simply make demand on all creditors that received checks during the preference period and leave it to the creditor to show why it is not a preference. In a large bankruptcy, this can mean that hundreds of demand letters will go out in the second year of the bankruptcy.

First, collect and protect information now, as soon as the debtor files bankruptcy. It will be harder to locate invoices and find salesmen two years from now. Collect a summary of all checks received from the debtor in the 100 days prior to the bankruptcy. A check received 100 days before the bankruptcy probably did not clear the debtor's bank until less than 90 days before the bankruptcy.

Then look at the invoices paid with each of the checks received. How old were each of the invoices at the time that the debtor's check cleared their bank? The trustee generally will not pursue any payments on invoices that were less than 60 days old, because those payments were in the "ordinary course of business."

Now pretend that you never received the payment and evaluate your ability to collect on these invoices. Again, this mostly boils down to security rights in the form of bond claims, mechanic's lien rights, personal guaranties, etc. Generally, you will have a defense to a preference claim if you could have enforced your rights to payment after the bankruptcy, even if the debtor had not sent you the check before the bankruptcy.

Look at each invoice and determine whether you have lien, bond or other security rights. This is going to be much easier to do now than two years from now. Your own documents and outside witnesses are easier to find now. Where

is this project? Who is the owner? Who is the general contractor? Were you still in lien rights at the time you received the payment? Was there a payment bond on the project and were you within time to make a payment bond claim at the time you received payment? If you were a secured creditor, generally the payment was not a preference.

You may actually need to file your lien or bond claims for money you have received. You may want to force the debtor and bankruptcy trustee to litigate the preference case now, while you still have lien or bond rights to protect you. It is often advantageous to bring the debtor, the bankruptcy trustee, the project owner, general contractor and the bonding company into the bankruptcy court early. Litigate the preference and your bond claim simultaneously with all parties in one courtroom. These parties may be helpful now in proving you had security and forcing the debtor to resolve a preference claim, but this help may not be available two years from now.

It is always important to be careful with lien and bond claim waivers, to make sure your security rights are not waived if a preference claim is brought against you later. This is discussed in other chapters of this book.[3] After bankruptcy you should deal the same way with your (1) uncollected receivable and (2) all money received during the preference period. "Spread" the invoices to figure out where all the material went and whether you have security rights for uncollected receivable and for payments received shortly before the bankruptcy filing.

Defending Preference Claims

You will eventually receive a letter asserting that you received payments during the 90-day preference period prior to the bankruptcy filing. This letter will demand that you pay this amount back to the bankruptcy court. At this point you should consider hiring an attorney, depending on the dollar amount or the issues involved. You or your attorney should request further information on the payments they allege are preferences. They can at least give you a copy of a computer printout showing the check numbers and dates.

This type of case can often be settled for about 50 cents on the dollar, especially in the early stages or before a suit is filed. If your defenses are better, you have a better chance of getting a good settlement. Unfortunately, you have to decide now whether you would rather just try to settle this claim for about 50 cents on the dollar or spend significant administrative time analyzing the accounts for defenses and later incur legal fees in defense.

You should confirm whether your company received this "Preference" amount during the 90 days prior to the bankruptcy. You should evaluate the strength of your defenses. You will then know more about the case than the lawyer on the other side. If you have no real defenses to the preference claim, you want to work hard on settling the case for less than the full amount of the debt. If you have some arguable defenses, you may be able to settle for a small percentage.

There are a few truly solid preference defenses. If you are sure you have a solid defense and the bankruptcy estate refuses to dismiss the case, your attorney can consider a motion for summary judgment to get the case thrown out of court.

Policy Conclusions

When a customer files bankruptcy, a creditor has a basic policy decision: whether to "participate in the bankruptcy process." Bankruptcy is a battle between innocent creditors. The bankruptcy process is an attempt to maximize the distribution to general unsecured creditors.

If a creditor tries to establish mechanic's lien rights, payment bond rights, trust fund or equitable lien rights, reclamation rights or some other priority, this will lower the amount available to general unsecured creditors. It may maximize this particular creditor's recovery, but it will lower the recovery to their brethren. This activity will also result in increased legal fees. The creditor will expend higher legal fees trying to establish priority. The debtor, the trustee and the unsecured creditors committee will fight the creditor in order to preserve money available for distribution. This further depletes the estate, whether the creditor succeeds in establishing priority or not.

If there is a genuine chance of a good distribution to general unsecured creditors, all creditors have a common interest in lowering the heat level, participating peacefully in the bankruptcy process and maximizing the distribution for all involved. For this reason it is important to evaluate the initial schedule of assets and liabilities and watch the activities of other creditors to evaluate the chances of a good distribution.

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[3] *See* chapter, Contract Terms and Preserving Rights; section, Contract Administration; subsection, Waiver Forms.

If there is little chance of a good distribution for general unsecured creditors, then each creditor has a stronger incentive to try and establish priority rights. The creditor's worst case is that it will waste time and money on legal fees. If there is no chance of a distribution from bankruptcy, this is not a risk, only an expense.

Unfortunately, the experience for most unsecured creditors is that they *never* see any distribution from a bankruptcy or very small distributions. Accordingly, most creditors are cynical of the bankruptcy process and will always do their best to establish their own priority over other creditors. This becomes a self-fulfilling prophecy. All creditors are pushing their own self-interest, expending legal fees in the process. The debtor, the trustee, the bankruptcy court and the unsecured creditors committee are all expending time and money fighting these creditors. This process further reduces the likelihood of any distribution.

INTRODUCTION

The Importance of Security

Why are one-year adjustable mortgage rates 6%, while some credit cards charge 18% interest per annum? Each dollar costs the bank the same amount. How can it be cheaper to lend one dollar than the other? Security is the most important difference. Security increases the bank's chances of *preventing* default and collecting its money within terms. In the event of default, the bank increases its chances of collecting faster and at lower cost.

Why does security decrease the risk of non-collection? When you purchased your last home or automobile, the bank required you to sign at least two pieces of paper. One was your promissory note. This was your "contract" with the bank in which you agreed to make certain monthly payments. This is your "personal promise to pay." This allows the bank to sue you personally in the event of default.

The other paper you signed was a mortgage, deed of trust or other "security agreement." Your security agreement provides the bank rights against the "security property." In the event of default, the bank can foreclose upon the security property, whether it is a house, automobile or other property.

If the debtor is solvent, security is not as important. The lender will be able to go against the debtor on the "contract." The lender will be able to obtain a personal judgment against the debtor and will then be able to attach all assets owned by the debtor. This is discussed in other chapters of this book.[4]

If the debtor is insolvent or disappears, security becomes critical. The contract or promise to pay will be worthless if the debtor cannot be found or is insolvent. The lender with only a contract or personal promise to pay is a "general unsecured creditor." All of the general unsecured creditors go in one "big pot." All of the assets of the debtor *that are not encumbered by a security interest* also go in the same big pot. The general unsecured creditors share pro rata in the available assets, according to the amounts of their claims.

It does not matter which creditor filed their proof of claim first or who was the first to jump in the big pot. A bankruptcy estate is similar to a probate estate when someone dies. It is no coincidence that they are both referred to as an "estate." The objective is to "liquidate" the assets of the estate that are not encumbered by a security interest and then distribute the proceeds to creditors, pro rata, to the extent possible.

Those of you who have experience as a general unsecured creditor in a bankruptcy know that this usually means you will be paid nothing or a very small percentage of your claim. By definition, if a debtor is in bankruptcy, it has very few unencumbered assets to go in the big pot for distribution to general unsecured creditors. Almost all of the debtor's assets are encumbered by liens to some lender, and the debtor's liabilities generally exceed its assets.

In the event of bankruptcy, the "secured creditor's" rights in the "security property" are generally not affected by the bankruptcy. The debtor has, in effect, disappeared and the lender's contract rights against the debtor are now worthless. However, the secured creditor, while perhaps delayed[5] from foreclosing against the property, will eventually collect as long as there is sufficient equity in the property.

Secured creditors generally have the option of simply "riding out" the bankruptcy. The debtor may eventually obtain a "discharge" from the debt as a matter of personal liability. A discharge from personal liability, however, will not eliminate the lien or security interest of the lender in the security property. After the debtor has obtained

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[4] *See* chapter, Enforcement of Judgment.

[5] *See* section below, The Bankruptcy Filing; subsection, Automatic Stay.

a discharge and the bankruptcy is closed, the "automatic stay" is also terminated and the secured lender is free to foreclose upon the security property.[6]

Secured lenders are often not satisfied to wait this long and can also request from the bankruptcy court a "relief from the stay."[7] If the debtor has no equity in the security property and the property is not necessary to a reorganization of the debtor, the bankruptcy court will probably grant the secured lender relief from the stay. The secured lender will now be free to foreclose.

Security can be either "consensual" or "judicial." Consensual security is provided with the consent of the debtor and is available to all types of lenders. Customers can agree to provide blanket consensual security applicable to all projects, such as personal guaranties, letters of credit or security interests in accounts receivable and equipment. These devices would be helpful to suppliers in any business, including construction materials, food service or equipment dealers.

Most of the companies you are doing business with have a large credit line for the operation of their business. The bank that provides this credit line probably required a blanket security interest on all of the accounts receivable of the debtor and/or all of the debtor's contract rights, inventory and equipment.[8] If the company purchased trucks, vehicles or heavy equipment, the seller of the equipment or a bank financing the acquisition again probably required a security interest. If the company owns real estate, there is probably a mortgage to a bank. All of these encumbered assets will not go in the big pot to be shared by general unsecured creditors, until the secured creditor has been paid in full. The bottom line in bankruptcy is that secured creditors get some or all of their money while unsecured creditors get very little or nothing.

Construction contractors and suppliers that have mechanic's lien or payment bond rights are generally in the same position as a secured lender. Mechanic's lien rights in most states are a security interest that will survive bankruptcy and result in secured creditor status. In states such as Maryland that do not have "inchoate" mechanic's lien rights, contractors and suppliers may be general unsecured creditors. Some states have higher priority on mechanic's liens than others. This is something that a contractor needs to understand in each state in which they are doing business. Mechanic's lien rights vary from state to state and are discussed in greater detail in other chapters of this book.[9] Rights under payment bond or guaranties generally will also be unaffected by bankruptcy. Unless the bonding company or guarantor is a debtor in bankruptcy, the creditor is still free to enforce rights under payment bonds or rights under guaranties.[10]

"General *un*secured creditors," however, will share only in assets that are not already encumbered as security property for a secured lender. Typically, there are not many unencumbered assets. If there were, there would probably not have been a bankruptcy.

Creditors versus Creditors

Bankruptcy is often not a battle between the debtor and a creditor. It is a battle between creditors. Secured and unsecured creditors are certainly adverse. If a bank can prove it properly filed a UCC financing statement on accounts receivable,[11] those assets are pulled out of the big pot and there is less for unsecured creditors to share. If a construction material supplier can establish mechanic's lien rights, this will give them "priority" in that particular receivable. That material supplier will be paid in full, leaving less for the unsecured creditors. If the material suppliers had failed to perfect mechanic's lien rights, however, this supplier would be another general, unsecured creditor. This receivable would be snatched up by another mechanic's lien claimant or would go into the big pot to be shared with other unsecured creditors. The debtor doesn't care which creditor gets this asset. The debtor will not get any of the assets.

Similarly, unsecured creditors are adverse to other unsecured creditors. The more unsecured creditors in the big pot, the less there will be to go around. If you are the only unsecured creditor that files a "Proof of Claim," you may get all available funds.[12] All secured and unsecured creditors are entitled to be paid. Fairness and justice would

[6] *See* section below, The Bankruptcy Process; subsection, Objection to Discharge.

[7] *See* section below, The Bankruptcy Filing; subsection, Automatic Stay.

[8] *See* chapter, UCC Security Agreements.

[9] *See* chapters, Mechanic's Lien Rights and General Principles, Mechanic's Liens in Virginia, Mechanic's Liens in Maryland, Mechanic's Liens in Pennsylvania and Mechanic's Liens in the District of Columbia.

[10] *See* chapter, Performance and Payment Bonds.

[11] *See* chapter, UCC Security Agreements; section, Perfection of Security Interest.

[12] *See* section below The Bankruptcy Filing; subsection, Proof of Claim.

dictate that all of them get their money. Bankruptcy, however, is a battle between "innocents." The "bad guy" is gone. All that is left are "good guys" that never bargained for problems with the debtor. The bankruptcy process tries to provide order and fairness for the innocents battling over the limited assets.

Paradigm Shift

Creditors and their lawyers spend a lot of time trying to collect money. Especially when debtors are in default of their payment obligations, an adversarial relationship develops between creditor and debtor. The debtor is trying to keep from paying money at all or any sooner than they have to. The creditor is trying to get as much money as they can as fast as they can.

The creditor's frame of mind is to "win" this contest against the debtor. It is only fair that the debtor pay. The debtor agreed to pay in a solemn promise or contract. The creditor has delivered all labor and materials promised to the debtor. The debtor should perform its promises as well. This is only fair. The creditor is only looking for justice.

The creditor tends to take this same frame of mind into the bankruptcy forum. The creditor is still, of course, only trying to collect money rightfully due, and has still lost the value of all labor and materials supplied. The bankruptcy rules seem to thwart this basic justice, making it complicated and difficult for a creditor to collect debts justly due and owing. Why is this? Why do bankruptcy law and the bankruptcy court favor the debtor and make it so difficult for a creditor to obtain justice? The debtor often continues in business. The officers and directors of the debtor are often still seen running the company and driving the same valuable automobiles.

We could debate endlessly whether or not the bankruptcy process is fair or proper. We will not attempt to solve that problem. In order to understand *how* the bankruptcy works, however, the creditor must understand the philosophic foundation of this system. There is no doubt that many debtors abuse the bankruptcy process or that the system could use reforms. On the other hand, there must be good reasons a bankruptcy system has survived over 100 years in most civilized countries. The U.S. Congress passed the current Bankruptcy Code into law after seeking the advice of many experienced lawyers, judges and academics. Federal courts enforce the Bankruptcy Code as the law of the land and an important public policy objective. What are all these people thinking? This is not a conspiracy of insolvent debtors to avoid justice. Penniless individuals and insolvent companies have not succeeded in thwarting justice and the wishes of the successful and healthy businesses in this country.

The creditors of the world must step outside of their normal frame of mind in order to understand the bankruptcy system. There are important public policy considerations that make a Bankruptcy Code important to society as a whole. More importantly, however, bankruptcy is *not* a contest between the creditor and the debtor. Rather, the Bankruptcy Code is an attempt to generate fairness between a large number of participants, including all creditors, all employees of the debtor, the public at large, and the debtor itself.

In his influential book, *The Seven Habits of Highly Effective People*, Dr. Stephen Covey explains the importance of an ability to make a paradigm shift in order to be successful. There are as many points of view as there are people in this world. We can never succeed unless we can *understand* other points of view. Creditors will never succeed in the bankruptcy process until they understand the objectives of the Bankruptcy Code.

Public Policy

In Medieval times, the government did put debtors in prison. This would seem fair to many creditors. The moneyed aristocracy made the rules. If you did not keep your agreements and pay your debt, creditors could make sure you were really sorry.

While creditors did obtain some satisfaction through this system, there were some obvious problems. Debtors could not earn any money to repay debts while they were in jail. Even worse, the government was financing their room and board. On a larger philosophic level, society needed a system that encouraged risk taking and entrepreneurship. Why would anyone take a risk in starting a new business venture if failure meant spending the rest of your life in jail? We do not need potentially productive members of society sitting in jail at government expense. We need them out working at their jobs and caring for their families. Why would anyone get up and go to work everyday if all of what they earned for the rest of their lives would go to creditors? Not only was the debtor-prison system inhumane and costly, it decreased production and suppressed economic activity.

We as a society eventually decided that we needed a system that allowed individuals to obtain a clean bill of health, emerging debt free and encouraged to go back to work. Debtors would have to give up all assets they had. Those assets would be distributed fairly between creditors, but all debt would otherwise be "discharged" and eliminated.

Have you ever wondered why every civilized country in the world has limited liability entities? Creditors often perceive great unfairness when a corporation disappears with one swipe of a pen, but the former corporate president can still be seen driving her Cadillac in the neighborhood. Some of the first limited liability entities in history were the Dutch and English trading companies in the Age of Exploration. Why would entrepreneurs risk borrowing money to build ships and explore the world for new trading partners and natural resources when the result could so easily be financial failure, debtor's prison and a lifetime of repaying creditors?

Modern society needs entrepreneurs to create new businesses, new products and new jobs. This isn't going to happen if entrepreneurs face a lifetime of ruination. When dealing with a corporation, limited partnership, LLC or other limited liability entities, you as a creditor simply have to understand that you will only be paid if the business succeeds. If creditors are not satisfied with this arrangement, they must decide to deal only with sole proprietorships or to always require personal guaranties. This would certainly limit the creditor's opportunities to do business.

When businesses fail, society often has a strong interest in finding a way to let the business continue. Historic problems with the steel, coal and railroad industries are good examples. Bethlehem Steel has "failed." They are no longer paying their debts as they become due. Liabilities exceed assets and the company has a negative net worth. Are we better off if Bethlehem Steel disappears from the face of the earth? Tens of thousands of people will be out of work. The nation would lose a major source of steel, an important component of national industrial production. Recovery by creditors will also be *limited*.

If an insolvent company is "liquidated," when liabilities exceed assets, secured creditors will probably lose money while unsecured creditors are left with nothing. If the company has a workable, basic business plan, however, continuing the business will mean the generation of profits to pay unsecured creditors, jobs for employees, a tax base for the government and a steel supply for industry.

Indeed, the shareholders often change in a "reorganized" corporation. When liabilities exceed assets, there is no "equity" for the shareholders (equity owners). Employees may become partial owners in exchange for lost pensions or the agreement to continue working. Unsecured creditors may receive stock instead of cash repayment of loans. Secured creditors sometimes become the "owners" of companies by agreeing not to foreclose on machinery and other assets.

This becomes all the more confusing because the former shareholders and managers of the failed business may continue as players. This can create the perception that the business continues unchanged while general unsecured creditors remain unpaid. The former shareholders and managers, however, may be mere employees in the reorganized company. The business may have failed only because of uncontrollable market conditions and the former managers may still be the best managers to work for the new employee or creditor owners. The former shareholder owners of the company must contribute cash or other "new value" to the reorganized venture in exchange for stock in the new reorganized company. They may also receive stock over time based on the success of the venture or services provided over time.

In general terms, the secured and/or unsecured creditors of the failed business become the owners and can make whatever deal they deem advisable with the former owners of the failed business. Generally, the old equity owners must lose their interest in the company unless they contribute genuine new value or the creditors are paid in full. This is known as the "absolute priority" rule.

Bankruptcy Timeline and Terms

The bankruptcy timeline can generally be depicted as follows:

	Bankruptcy Filing = Petition	**Discharge Plan Confirmation**
Pre-petition	**Post-petition**	
90 Days Preference Period	**Stay**	**After Bankruptcy**

The bankruptcy process normally begins when the debtor files a "bankruptcy petition." All transactions that occurred with the debtor before that time are now called "pre-petition." All transactions after that are called "post-petition." It often becomes important whether a debt is pre-petition or post-petition. It is the pre-petition unsecured debt that goes into the big pot and shares in any eventual distribution to any general unsecured creditors. A debt for labor or materials supplied after the date of bankruptcy is post-petition debt, which is of higher priority and more likely to be paid.[13]

Immediately upon the filing of a Voluntary Petition in Bankruptcy, an "Order for Relief" is entered. In an Involuntary Petition, the court will enter an Order for Relief after the debtor is given an opportunity to oppose the petition.

Once the order for relief is entered, the bankruptcy process begins and the "automatic stay" is in place. The automatic stay ends the "race to the courthouse." All creditors are forbidden from taking aggressive action against the debtor or otherwise improving their position. General unsecured creditors will not be able to secure the amount owed to them, by judgment or otherwise. The debtor is no longer permitted to simply pay any creditor they wish.[14] This automatic stay is one of the most important policy objectives of the Bankruptcy Code. All creditors are forced to simply stop aggressive behavior and participate in an orderly bankruptcy process.

This policy objective is so important that the Bankruptcy Code effectively pretends that the bankruptcy petition was filed 90 days earlier. The 90 days prior to the bankruptcy petition is called the "preference period." Not only are creditors prohibited from improving their position after the bankruptcy petition, the Bankruptcy Code also "undoes" or eliminates many things that improved a creditor's position in the 90 days prior to the bankruptcy period.[15] Any payments made by the debtor during the preference period may have to be repaid by creditors. If a creditor obtained a security interest in property of the debtor during the preference period, this lien can be removed.

The policy behind the automatic stay and preference period is to encourage creditors to work with a debtor, rather than force them into bankruptcy. A creditor is less likely to be aggressive with a debtor if the creditor knows that a bankruptcy petition within 90 days can mean that the creditor wasted legal fees for a judgment, garnishment, security interest or other aggressive attempts to collect.

Mechanic's lien rights are an important exception to this rule. In a state with an "inchoate" mechanic's lien, the contractor or supplier has mechanic's lien rights from the moment they supplied labor or materials. Accordingly, perfecting mechanic's lien rights is not a preference in such states. This is discussed in greater detail in other chapters of this book.[16]

Accordingly, advanced planning is very important in establishing security rights. If a creditor is depending on consensual security, the creditor must make sure to get this at least 90 days before a bankruptcy filing. The only way to be safe is to require some type of security before supplying labor and materials.

By the same token, it is important to determine whether payment bond rights exist and to evaluate your mechanic's lien rights *before* supplying labor and materials. If you are doing business in a state with strong inchoate mechanic's lien rights, you do not need to be as concerned with consensual security. If your mechanic's lien rights will be limited or lost in bankruptcy, however, it becomes more important to require security early.

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[13] *See* section below, Doing Business with the Debtor in Bankruptcy.

[14] *See* section below, The Bankruptcy Filing; subsection, Automatic Stay.

[15] *See* section below, Preferences.

[16] *See* chapter, Mechanic's Liens in Virginia; section, Time Limits for Memorandum of Mechanic's Lien; subsection, Effect of Bankruptcy.

Types of Bankruptcy

Chapter 7

This is a liquidation. All of the unencumbered assets of the debtor are thrown into the big pot. All of the general unsecured creditors are also thrown into the big pot and share pro rata in whatever assets are available (share pro rata in the proceeds of the liquidation). Secured creditors have their rights in their collateral and will be paid in full if there is enough equity in the security property.

An individual person can file a Chapter 7 and obtain a "discharge." The individual emerges from bankruptcy with no debts, and only those assets exempt under the code.[17] An individual will obviously continue to exist. The debtor is still responsible for post-petition debts and cannot get another discharge in bankruptcy for six years.[18] This individual may not have been a good business risk and may have been poor at handling credit, but many creditors will want to do business with an individual after bankruptcy. Creditors can often charge premium rates and need not worry about another bankruptcy for six years.

A corporation or other limited liability entity can also file a Chapter 7, but this is less common. A corporation cannot receive a discharge in Chapter 7. The corporation is simply out of business. If a corporation is insolvent, it is not normally worth it to pay legal fees or filing fees for a bankruptcy. The business is simply abandoned. Creditors are free to obtain judgment but will be unable to collect.

Sometimes corporations will file Chapter 7 in order to wind down the business in an orderly manner. There may be a few profitable projects or contracts that the debtor wishes to complete. The bankruptcy and automatic stay will keep creditors from harassing the debtor while this occurs. Indeed, the automatic stay may be the only reason a corporation files a Chapter 7 bankruptcy. Legal fees and administrative time may both be lower if general unsecured creditors are forced to stop aggressive action. The profits collected while the business is wound down may all go to a secured creditor with a security interest in all accounts receivable and the personal guaranty of officers and directors.

Creditors are not normally faced with the decision whether to do business with the debtor post-petition in a Chapter 7, but creditors should be especially cautious of a corporate debtor requesting credit in a Chapter 7. By definition, the business will disappear. The creditor does have "administrative expense priority" for the post-petition debt, but there may be no assets, cash flow or debtor from which to collect.[19]

Chapter 11 Reorganization

This is usually only for corporations and other limited liability entities. The corporation can eventually develop a "plan of reorganization" and can continue in business. Secured creditors will normally retain their collateral rights. Unsecured creditors will have their right to a pro rata distribution of the unencumbered assets and may get a portion of future profits or a shareholder interest in the reorganized entity.

In general terms, the debtor can continue "business as usual" after the Chapter 11 petition. Normally, the management of the debtor remains in control of the business as a "debtor in possession."[20] The debtor in possession is authorized to operate the business and incur unsecured debt in the ordinary course of business.[21] This post-petition unsecured debt will have administrative expense priority.[22] There is no need for the debtor to get bankruptcy court approval to incur trade debt or pay such post-petition trade creditors in the ordinary course of business.[23]

A Chapter 11 debtor can convert the case to a Chapter 7 liquidation at any time. Creditors sometimes request the bankruptcy court to convert the Chapter 11 to a Chapter 7 liquidation, if creditors feel that a continuation of the business will just deplete assets and there is little chance of a successful reorganization.

There is such a thing as a Chapter 11 liquidation. This is similar to a Chapter 7 liquidation. All of the assets of the corporation will be sold, and the debtor will go out of business. Chapter 11 liquidations are preferred sometimes, however, in order to wind down the business of the corporation in the most profitable manner.

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[17] *See* section below, The Bankruptcy Process; subsection, Objection to Exemptions.

[18] 11 U.S.C. §727.

[19] *See* section below, Doing Business with the Debtor in Bankruptcy; subsection, Administrative Expense Priority.

[20] *See* section below, The Bankruptcy Process; subsection, The Trustee.

[21] 11 U.S.C. §1107; 11 U.S.C. §364(a).

[22] 11 U.S.C. §364(a); *See* section below, Doing Business with the Debtor in Bankruptcy; subsection, Administrative Expense Priority.

[23] *See* section below, Doing Business with the Debtor in Bankruptcy.

Normally, the objective of a Chapter 11 reorganization is to continue in business. Eventually, a "plan of reorganization" is adopted. Most plans of reorganization call for secured creditors to retain their collateral rights. If there is sufficient value in the collateral, the secured creditor will eventually be paid most or all of what they are owed. Federal, state and local governments usually are also paid in full for tax liabilities. General unsecured creditors will receive some percentage of their debt, to be paid over time as the reorganized business generates profits. The plan will typically call for the shareholders or equity holders in the business to lose some or all of their ownership interests. There is usually some change in the ownership of the entity in the plan of reorganization. Secured creditors, unsecured creditors or employees may become the owners of some or all of the reorganized entity.

Only the debtor is allowed to propose a plan of reorganization for the first 18 months after the bankruptcy petition.[24] This deadline cannot be further extended by the court.[25] If the debtor's plan has not been filed or accepted within deadlines, the trustee, creditors committee, an individual creditor or another party in interest may file a reorganization plan.[26]

Under a plan, all creditors are separated into "classes," such as secured, unsecured, equity owners, governmental taxes, etc.[27] All creditors in each class must be treated the same under the plan. Creditors that will receive less than payment in full are "impaired." Creditors that will not lose any rights are "unimpaired."[28]

All creditors will eventually receive a "disclosure statement" describing the plan and the debtor's financial circumstances. All impaired creditors with allowed claims will have an opportunity to vote on the plan.[29] Unimpaired creditors are conclusively presumed to have accepted the plan, since they will be paid in full.[30]

Each impaired class of creditors must accept the plan or the court must determine that a "cram down" is appropriate.[31] A class of creditors has accepted the plan if more than ½ of the creditors have voted in favor *and* ²/3 of the amount of the claims in the class have voted in favor of the plan.[32] If one class of creditors has not approved the plan, the court can still approve the plan by "cram down," if all creditors in the class will receive at least as much as they would have under a Chapter 7 liquidation.[33] In any event, however, at least one impaired class of creditors must accept the plan.[34] This requirement sometimes causes debtors to artfully create classes of creditors, in order to make sure that one impaired class approves the plan. Once these and other requirement are met, the court can "confirm" the plan.

Once the plan of reorganization is confirmed, the corporation does obtain a discharge from general unsecured debt that arose before plan confirmation, whether or not a proof of claim was filed.[35] All property of the bankruptcy estate becomes vested back in the debtor. That property is free and clear of all claims of creditors or shareholders in the former company.

In a Chapter 11 reorganization case, the code states that "debts were discharged upon confirmation of a plan." Bankruptcies are sometimes dismissed, however, if the debtor does not make agreed payments under a plan. Chapter 11 bankruptcy is sometimes filed by wealthy individuals with complex business affairs. In an individual Chapter 11, debts are not discharged until all payments are made under a reorganization plan.[36]

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[24] 11 U.S.C. §1121(b).
[25] 11 U.S.C. §121(d).
[26] 11 U.S.C. §1121(c).
[27] 11 U.S.C. §1122.
[28] 11 U.S.C. §1124.
[29] 11 U.S.C. §1126.
[30] 11 U.S.C. §1126(f).
[31] 11 U.S.C. §1129(a)(7).
[32] 11 U.S.C. §1126(c).
[33] 11 U.S.C. §1129(a)(7).
[34] 11 U.S.C. §1129(a)(10).
[35] 11 U.S.C. §1141.
[36] 11 U.S.C. §1141.

There is a Chapter 11 reorganization process for "small business debtors," with debts of less than $2 million. Some procedural rules are relaxed. For example, the debtor can dispense with a "disclosure statement" to all creditors, if the plan of reorganization itself provides adequate information for creditors to vote on the plan.[37] This may help small businesses get out of bankruptcy faster and successfully reorganize. Other rules regarding the automatic stay are applicable only to small business cases.

In a small business reorganization, the debtor has an exclusive right to file a plan of reorganization for only 100 days after the petition. This can be extended by the court, but extensions become more difficult more than 300 days after the petition.[38] This will make it easier for creditors to have a case dismissed or converted to a Chapter 7, if no plan of reorganization has been approved within these deadlines.

Chapter 13 Plan

This is like a Chapter 11 reorganization for individuals. The individual develops a plan that usually involves putting all "disposable income" in the big pot to be shared by all general unsecured creditors. Secured creditors have their collateral rights and will be paid in full if there is sufficient equity in the collateral. The individual gets to keep a large portion of their income during the Five-Year Plan for living expenses, and general unsecured creditors normally receive only a small percentage of their claim. Only individuals with "regular income," basically salaried individuals, can file Chapter 13.

Individuals normally elect to file a Chapter 7, because they can receive an immediate discharge, start a new day free of any debt and are able to keep all of their future income. Some people file a Chapter 13 out of a sincere desire to repay creditors to the best of their ability. Others utilize Chapter 13 in order to schedule out a non-dischargeable tax claim. Often, individuals file a Chapter 13 in order to obtain a discharge from debts that may be non-dischargeable in a Chapter 7. This is usually some type of fraud claim.

Involuntary Bankruptcy

It is possible for three creditors to put an individual or corporation into an involuntary bankruptcy.[39] The three creditors must have claims that are not contingent and not the subject of a bona fide dispute.[40] The bankruptcy court will enter an order for relief and start the bankruptcy process if the debtor is generally not paying its debts as they become due.[41]

The debtor can continue to operate the business, but creditors can ask the court to appoint a trustee to take control of the business.

The involuntary bankruptcy petition could be Chapter 7 or Chapter 11. In either case, however, the debtor or creditors can later ask to have the case converted to another chapter.[42]

Creditors may want to file an involuntary petition because the debtor is quickly losing money and creditors will be better off if all assets are immediately liquidated. Creditors may also want to file an involuntary bankruptcy if they think there is fraud in the company, gross mismanagement or if management is paying select creditors at the expense of others. Unpaid creditors may file an involuntary petition to establish the right and the timetable to require repayment of preferences.

For any individual creditor, an involuntary petition is often more valuable as a threat than action. Once the involuntary bankruptcy process begins, the creditor is not able to appropriate for itself the benefit of this action. All of the debtor's creditors will be involved and all of the debtor's assets must be equitably distributed pursuant to the Bankruptcy Code. All of the transaction costs and inefficiencies of any bankruptcy will exist and the eventual distribution to general unsecured creditors may be small. Petitioning creditors can recover the costs of filing a successful involuntary petition as an administrative expense. On the other hand, petitioning creditors may have to pay legal fees if they fail to prove that the debtor is legally bankrupt.[43] Punitive damages are a possibility if the involuntary petition was filed in bad faith.

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[37] 11 U.S.C. §1125.
[38] 11 U.S.C. §21(e).
[39] 11 U.S.C. §303.
[40] 11 U.S.C. §303(b).
[41] 11 U.S.C. §303(h).
[42] 11 U.S.C. §706; 11 U.S.C. §1112.
[43] 11 U.S.C. §303(i).

Foreign Bankruptcies and Creditors

The Bankruptcy Code generally adopts the Model Law on Cross-Border Insolvency from the United Nations Commission on International Trade Law. The objective is cooperation between courts of the United States and courts of other countries in cross-border insolvency cases; greater legal certainty for trade and investment; and fair and efficient administration of cross-border insolvencies.

The process starts with a foreign insolvency proceeding. A "foreign representative" may then request recognition of the foreign proceeding in a United States Bankruptcy Court in a district where the debtor has its principal place of business or principal assets or where a judgment enforcement proceeding is pending.[44] Once the foreign bankruptcy is recognized, the foreign representative can act for the debtor in the United States Bankruptcy Court. The foreign representative has the automatic right to operate the debtor's business as a "debtor in possession."[45] Several U.S. Bankruptcy Code provisions will apply, including the automatic stay provisions that will now apply to assets of the debtor in the United States.[46] Creditors must be careful about violating the automatic stay as to foreign-owned property in the U.S.

Foreign creditors are also now entitled to non-discriminatory treatment in any U.S. bankruptcy with "the same rights regarding the commencement of, and participation in, a case under this title as domestic creditors."[47] They are entitled to the same notices given to creditors generally.[48]

Consumer and Individual Bankruptcies

Means Testing

Means Testing is designed to eliminate abuse by individual debtors by preventing individuals with high income from filing for a Chapter 7 discharge. The trustee or a creditor can request dismissal of a Chapter 7 case if the debtor's income is above the median income in that geographic area and the debtor has "sufficient available net income."[49] There are complicated formulas to qualify a debtor, but a creditor can generally ask the court to dismiss a case if a debtor has available net income of at least $10,000 over a five-year period for repayment of debts. If a debtor consents, the case can be converted to a Chapter 13, instead of dismissed, which has always required the debtor to repay a portion of debts over time.

These provisions may aid a commercial vendor that sells goods to an individual consumer or a creditor seeking to enforce a personal guaranty of a commercial account.

Credit Counseling

Individual debtors are also required to take mandatory credit counseling and education in order to obtain a bankruptcy discharge.[50] This makes it more difficult generally for debtors to file bankruptcy and will hopefully avoid subsequent bankruptcies through education. A debtor must obtain credit counseling and perform a personal budget analysis from an approved nonprofit budget and credit counseling agency *before* filing a bankruptcy petition. In addition to pre-bankruptcy credit counseling, debtors must also complete a course on personal financial management in order to receive a discharge in Chapter 7 or Chapter 13.[51]

Discharge Every Eight Years

There must be eight years between discharges under Chapter 7 or Chapter 11.[52] In Chapter 13, no discharge is available to a debtor that received a discharge in a Chapter 7, 11 or 12 Bankruptcy filed within four years prior to the current Chapter 13. A Chapter 13 debtor cannot also receive a discharge in a new Chapter 13 case filed within two years prior to the new Chapter 13 petition.[53]

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[44] 11 U.S.C. §1504; 28 U.S.C. §1410.
[45] 11 U.S.C. §1520.
[46] 11 U.S.C. §1519 and §1520.
[47] 11 U.S.C. §1513 (a).
[48] 11 U.S.C. §1514.
[49] 11 U.S.C. §707(b).
[50] 11 U.S.C. §109.
[51] 11 U.S.C. §727(a)(11) and 11 U.S.C. §1328(g).
[52] 11 U.S.C. §772(a)(8).
[53] 11 U.S.C. §1328(f).

Homestead Exemptions

Homestead Exemptions protect certain types of property of an individual debtor from creditors. Homestead exemptions, created by state law, have generally been respected by the Bankruptcy Code. These exemptions vary from state to state. Florida, Iowa, Kansas, South Dakota and Texas have unlimited Homestead Exemptions for a debtor's personal residence. This has resulted in much abuse as debtors sliding into insolvency in any state would liquidate all available assets, move to a state with an unlimited homestead exemption and buy a mortgage-free mansion. Once residence is established, the debtor would then file bankruptcy, discharge all debt and still have an unlimited asset in the personal residence.

There are complicated provisions restricting abusive use of homestead exemptions. Homestead exemptions are restricted, regardless of state law, to $125,000 if the debtor bought their residence less than 40 months before the bankruptcy filing.[54] The debtor also loses their exemption as to any property disposed of in the 10 years prior to the bankruptcy petition with the intent to hinder, delay or defraud a creditor.[55] Assets protected from creditors in individual retirement accounts are also now generally limited to $1 million.[56]

THE BANKRUPTCY FILING

Notice of Bankruptcy

When a debtor files bankruptcy, you should receive a "Notice of Bankruptcy" (example in the Appendices) if you are a creditor. The Notice of Bankruptcy is sent by the bankruptcy court clerk to all creditors listed by the debtor in their bankruptcy petition. The notice will state the name and address of the debtor that has filed bankruptcy and provide the name and address of the bankruptcy court. The notice will also identify the name and address of the debtor's attorney, the name and address of the bankruptcy trustee, and tell you whether the bankruptcy is a Chapter 7, Chapter 11 or some other type of bankruptcy.

Automatic Stay

The notice of bankruptcy will inform you:

Creditors may not take certain actions:

The filing of the bankruptcy case automatically stays certain collections and other actions against the debtor and the debtor's property. If you attempt to collect a debt or take other action in violation of the Bankruptcy Code, you may be penalized.

This is the "automatic stay." When a debtor files bankruptcy, creditors are automatically prohibited from taking action against the debtor or the debtor's property. The bankruptcy case may later be dismissed if the debtor fails to comply with their bankruptcy obligations. Creditors may bring a motion to "lift the stay" or dismiss the bankruptcy on various grounds.[57] Until the stay is lifted or the bankruptcy is dismissed, however, creditors are generally prohibited from harassing the debtor in any manner or taking affirmative steps to collect a debt.

Violating the automatic stay can result in severe penalties.[58] Creditors are not permitted to call or write the debtor in an attempt to collect, may not file suit and may not take any further action in any pending lawsuit. Creditors are also prohibited from taking any action against the debtor's property, may not foreclose on any security interest, may not file a mortgage or judgment lien, may not repossess a vehicle, may not evict a tenant from real estate, and may not take rented equipment.

The automatic stay is an important part of Bankruptcy Code policy. It ends the "race to the courthouse." Bankruptcy is intended to be an orderly process to liquidate or reorganize the debtor, and this is impossible if creditors are allowed to aggressively pursue the debtor. Fairness between creditors also is an important objective, and the debtor's limited assets should not go to the creditor that is the most aggressive or the creditor that can afford the most attorney's fees.

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[54] 11 U.S.C. §522(p).

[55] 11 U.S.C. §522(o).

[56] 11 U.S.C. §522(n).

[57] 11 U.S.C. §707; 11 U.S.C. §1112.

[58] *Joyce Eng'g, Inc. v. IRS*, 92 F.3d 1539 (11th Cir. 1996); *Mountain Am. Credit Union v. Skinner* (*In re Skinner*), 917 F.2d 444 (10th Cir.1990).

The automatic stay is often the very objective of a bankruptcy filing, if a creditor is about to foreclose on property or has just filed some other legal action. Debtors sometimes file bankruptcy just to temporarily stop some foreclosure action and will thereafter allow their case to be dismissed.

An important exception to the automatic stay is the right to file a mechanic's lien in states with inchoate mechanic's lien rights.[59] In states with inchoate mechanic's lien rights, contractors or suppliers have lien rights from the moment they supply labor and materials to a property. Accordingly, filing a mechanic's lien is not a preference and is not an affirmative action against the debtor or the debtor's property. The mechanic's lien only provides public notice of the lien that the creditor always had. Filing a lawsuit to enforce mechanic's lien rights, however, is normally a violation of the automatic stay and requires a motion for relief of the stay.[60]

Secured creditors are stayed from moving against their collateral. Secured creditors retain their security rights in the collateral, but they may not foreclose or repossess without filing a "motion for relief from the automatic stay" to obtain bankruptcy court permission.[61]

It is important to note that creditors are stayed only from taking action against *the debtor in bankruptcy* or against the property of *the debtor in bankruptcy*. Creditors often have rights against more than one debtor. If you have a contract with a husband and wife, and only the husband files bankruptcy, you may still take action against the wife. If a corporation files bankruptcy, but you have a personal guaranty from an officer, you may move against that personal guarantor. You may still enforce a payment bond claim, unless the bonding company happens to be in bankruptcy.

There are some limits on the automatic stay for "serial filers"—that is, debtors that repeatedly file bankruptcy petitions. Most of these provisions concern consumer bankruptcies, but some are also applicable to commercial debtors. [62]

Proof of Claim

The notice of bankruptcy will also provide a deadline for filing proofs of claim or instruct you *not* to file a proof of claim unless you receive further notice. It is very important to file your proof of claim before the deadline, because you have probably waived your claim otherwise.

A proof of claim is essentially a lawsuit against the debtor. While creditors are stayed from filing a lawsuit in other courts, they are permitted to make their claim against the debtor in the form of a bankruptcy proof of claim filed in the bankruptcy court. Creditors may also include any pre-petition and post-petition contract-based claims for attorney's fees in their proof of claim.[63]

A Proof of Claim form is in the Appendices. If a proof of claim is "allowed" the creditor is entitled to its pro rata share of any distribution from the bankruptcy estate (the big pot). Creditors have an important advantage in that their filed proof of claim is deemed accepted, unless the debtor, trustee or another creditor objects.[64] The debtor has the burden of introducing evidence to disprove your claim.[65]

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[59] *H.T. Bowling, Inc. v. Bain*, 52 Bankr. 58 (W.D. Va. 1985), *aff'd in part and rev'd in part* 64 Bankr. 581 (W.D. Va. 1986); *See* chapters, Mechanic's Lien Rights and General Principles and Mechanic's Liens in Virginia; section, Time Limits for Memorandum of Mechanic's Lien; subsection, Effect of Bankruptcy.

[60] *McCoy v. Chrysler Condo Developers Ltd. Partnership*, 239 Va. 321, 389 S.E.2d 905 (1990); *See* chapter, Mechanic's Liens in Virginia; section, Enforcement of Mechanic's Lien; subsection, Effect of Bankruptcy.

[61] *See* section below, Motions; subsection, Motion for Relief from the Stay.

[62] *See* section below, Motions; subsection, Motion for Relief from the Stay.

[63] State law determines whether contractually based attorney's fees are allowed. A claim for attorney's fees is allowed in bankruptcy "if valid under applicable state law." The United States Supreme Court held, "It remains true that an otherwise enforceable contract allocating attorney's fees (*i.e.,* one that is enforceable under substantive, nonbankruptcy law) is allowable in bankruptcy except where the Bankruptcy Code provides otherwise." *Traveler's Casualty and Surety Co. v. Pacific Gas and Elec. Co.*, 127 S. Ct. 1199, 167 L. Ed. 2d. 178 (2007). Creditors can also include attorney's fees incurred post-petition litigating issues in the bankruptcy. This is the majority rule and is followed by all circuit courts regarding pre- and post-petition contractually based attorney's fee claims. Many courts, however, limit recovery for post-petition attorney's fees to fees directly related to enforcement of the contract and will not enforce claims for fees incurred in the bankruptcy unless specifically stated in the contract. *See In re Abercrombie,* 139 F.3d 755 (9th Cir. 1998). The majority of courts will allow claims for attorney's fees incurred in the preparation and processing of the bankruptcy claim. *See In re United Merchants and Manufacturers,* 674 F.2d 134 (2nd Cir. 1982).

[64] 11 U.S.C. §502(a); FRBP 3001(f)—A proof of claim executed and filed in accordance with these rules *shall* constitute *prima facie* evidence of the validity and amount of the claim; *see also In re Fullmer*, 962 F.2d 1463 (10th Cir. 1992).

[65] *See In re Hartford Sands, Inc.*, 372 F.3d 637, 640 (4th Cir. 2004) [Debtor has the burden of introducing evidence to rebut the claim's presumptive validity by a preponderance of the evidence]; *see also In re Allegheny Intern, Inc.*, 954 F.2d 167 (3rd Cir. 1992) ["It is well established that in objecting to a claim against the Debtor, it is the burden of the objecting party to initially present sufficient evidence to overcome the *prima facie* presumption of validity of a validly filed proof of claim"].

Debtors usually do not have an incentive to object to any one particular claim, because all the debtor's assets will normally be split amongst creditors. The debtor will not end up with any assets and usually doesn't care how assets are distributed. Bankruptcy is often not a contest between the creditor and the debtor, but rather a contest between creditors. Consequently, another creditor or the trustee may file an objection to a proof of claim.[66]

On the sample Proof of Claim Form, creditors are asked whether they have ever received notices in this bankruptcy. As discussed below, creditors will receive bankruptcy notices only if the creditor was listed as a creditor in the bankruptcy petition schedule of liabilities. If you have never received bankruptcy notices, it is important to check this box on the proof of claim form in order to have your name added to the "matrix" mailing list for future notices. Similarly, the proof of claim form invites the creditor to list a new or different address for notices. A debtor will often list a creditor's address the same as the address used to send payments. For large corporate creditors, this may be a lock box address or main headquarters address. If future notices are sent to this address, it may take a while for these notices to be forwarded to the credit manager or other person making decisions for the creditor. Future notices could include a notice that the bankruptcy had been dismissed, an objection to a creditor's proof of claim or other important activities in the bankruptcy court. These deadlines are often very short, and it is important to get notices to decision makers promptly.

Box One of the proof of claim form asks for the "basis of claim." For construction contractors and suppliers, this will normally be either "goods sold" or "services provided" or both. The creditor is permitted to check more than one box.

Box Four of the proof of claim asks for the "amount of claim." This should be the total amount of the debt to this creditor as of the day of the bankruptcy petition, including principal, interest and service charges. Creditors should identify the "date debt was incurred" in Box Two and must separately account for the interest portion of the claim.

In determining the amount of claim for the purposes of Box Four, creditors should keep in mind that all debt for labor and materials provided pre-petition should be included. This amount includes charges for labor and materials provided pre-petition that were not invoiced until post-petition.

The creditor should identify any "security" for the debt in Box Five of the proof of claim. This asks whether the creditor has security in the property *of the debtor*. For example, the debtor could have provided the creditor with security interest or UCC financing statement in an account receivable, equipment or real estate. This could also be a mechanic's lien interest in the debtor's property. This would be true if you were supplying labor or materials directly to the owner of the real estate and that owner filed bankruptcy.

If your debtor was not the owner of the real estate (your debtor was a contractor or subcontractor), however, your mechanic's lien rights are not a security interest in the real property of the debtor. It may still be advisable to file a proof of claim as a secured creditor in this instance, however. Your mechanic's lien rights in an owner's property do give you priority over the receivable owed by the owner to your debtor. Your mechanic's lien interest is in the real estate of the owner (and not the debtor), but this gives you an interest in the receivable owed by the owner to the debtor. This receivable is property of the debtor.[67] It is not clear whether you are required to file a proof of claim as a secured creditor in this situation.

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[66] 11 U.S.C. §502(a); *In re Thompson*, 965 F.2d 1136 (1st Cir. 1992) [Trustee as party in interest may file objection to Proof of Claim]; *In re International Yacht and Tennis, Inc.*, 922 F.2d 659 (11th Cir. 1991) [Debtor in Possession as party in interest may file objection to Proof of Claim];

Even when there is an objection to your proof of claim, the court *shall allow* the claim unless your claim runs afoul of the Bankruptcy Code. According to the United States Supreme Court, a proof of claim shall be allowed except where the claim implicates any of the nine exceptions in §502(b) of the Bankruptcy Code and the claim is "unenforceable against the debtor... under any agreement or applicable law."

Those exceptions apply when the claim: §502(b)(1); "is for unmatured interest," §502(b)(2); "is for [property tax that] exceeds the value of the [estate's] interest" in the property, §502(b)(3); "is for services if an insider or attorney of the debtor' and 'exceeds the reasonable value of such services," §502(b)(4); is for unmatured debt on certain alimony and child support obligations, §502(b)(5); is for certain "damages resulting from the termination" of a lease or employment contract, §§502(b)(6) and (7); "results from a reduction, due to late payment, in the amount of... credit available to the debtor in connection with an employment tax on wages, salaries, or commissions earned from the debtor," §502(b)(8); or was brought to the court's attention through an untimely proof of claim, §502(b)(9). *Traveler's Casualty and Surety Co. v. Pacific Gas and Elec. Co.*, 127 S. Ct. 1199, 167 L. Ed. 2d. 178 (2007).

[67] *See In re Richardson Builders,* 123 B.R. 736 (W.D.Va. 1990); *In re Shore Air Conditioning & Refrigeration, Inc.*, 18 B.R. 643 (Bankr.D. NJ 1982); *In re R.E. Tull & Sons, Inc.*, 25 B.R.709 (Bankr. MD. 1982). *See* chapter, Mechanic's Lien Rights and General Principles.

The status of trust fund rights is also questionable on a proof of claim. These rights can exist as a result of state trust fund statutes or as a result of a trust fund agreement. This is discussed in other chapters of this book.[68] A trust fund claimant is probably not a "secured creditor" because they are not claiming a security interest in property of the debtor. This money is simply not property of the bankrupt debtor. The trust fund was always the property of the creditor, and the debtor was only a trustee. It is probably advisable to make note of a trust fund claim in Box Five on a proof of claim, however. An "equitable lien" claimant, however, is more likely an actual secured creditor in bankruptcy.[69]

Any secured creditor, trust fund or equitable lien claimant should engage counsel to file a proof of claim. It is tempting to view a proof of claim as simple and unimportant. If a creditor is owed a small amount of money and is satisfied with general unsecured creditor status, credit managers and other laypersons can usually file proofs of claim on their own. It is unlikely there will be a distribution in most bankruptcies anyway. A creditor that hopes to be paid in full should take care in a proof of claim, in order to avoid taking inconsistent positions. Counsel should generally file a proof of claim in any case involving a large amount of money, any type of secured claim, a trust fund or equitable lien claim, an administrative expense claim or any claim to full payment because of assumption of a contract.

Box Six of the proof of claim inquires whether the creditor has "unsecured priority" status. This would almost *never* be applicable to a construction contractor or supplier and generally involves employees of the debtor or governmental units.

The bottom of the proof of claim form instructs the creditor to attach documents relevant to the proof of claim, including contracts, invoices or evidence of a security interest. It is important to attach documents. This is an easy way to show evidence or further detail of your claim. Remember, the proof of claim is deemed accepted if the debtor does not object. This essentially gets all these documents "into evidence" in proving your claim. If you have a pending lawsuit against the debtor, it may be convenient to attach a copy of the lawsuit with exhibits. This is an easy way to provide detail on your claim.

The bottom of the proof of claim form also provides instructions if you want a "File Stamped Copy" of your proof of claim. This is always advisable, so that you have evidence in your file of the date of filing and contents of your proof of claim.

A creditor should make sure that all of its claims are included in the proof of claim, including all principal, interest and attorney's fees. Proof of claim can later be amended or supplemented, however. Make sure you file something before the deadline expires, even if you are missing some information or documents. You may be able to add this additional information later.

Schedules

Soon after filing bankruptcy, the debtor is required to file a schedule of assets and liabilities, a schedule of current income and current expenditures, and a statement of the debtor's financial affairs.[70] These are collectively referred to as "schedules." The debtor must file schedules along with its voluntary petition, unless the immediacy of the filing does not allow. In the event that the debtor or debtor's counsel must file the petition in a short amount of time, a list of the names and addresses of all the debtors' creditors can be filed along with the voluntary petition. Such a filing is known as a "bare bones petition." The filing of complete schedules within 15 days of filing the petition must follow a bare bones petition.[71] Similarly in an involuntary case, the debtor must file its schedules within 15 days after the entry of the order for relief.[72]

Any creditor will want to review these schedules before attending the meeting of creditors, in order to better question the debtor at the meeting. On larger and more complicated bankruptcies, the debtor will often get an extension of time to file these schedules. Bankruptcies are sometimes dismissed if the debtor never files schedules.[73]

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[68] *See* chapter, Trust Fund Laws and Agreements.

[69] *See* chapter, Equitable Remedies.

[70] 11 U.S.C. §521.

[71] FRBP Rule 1007.

[72] FRBP Rule 1007(a)(2).

[73] *In re Pike*, 258 B.R. 876 (S.D. Ohio 2001).

The schedules are essentially a complete financial statement of the debtor. The debtor is required to list all of its assets, secured creditors, unsecured creditors and income in the current year and past years.

The debtor is also supposed to list all creditors, the amount of the debt and whether the debt is "unliquidated," "contingent" or "disputed."[74] The debtor lists secured creditors on a separate schedule. In a Chapter 11, if a creditor is listed and the debt is not scheduled as unliquidated, contingent or disputed, then the creditor is deemed to have an allowed claim in the amount listed, even if this creditor fails to file a proof of claim. If a creditor wishes to claim a higher dollar amount or wishes to claim secured status, or if the debt is listed as unliquidated, contingent or disputed, then the creditor must file a proof of claim. It is advisable for all creditors to file a proof of claim, however, especially if the court has issued a "Notice of Need to File Proof of Claim," also known as a "bar date" order. In any event, all creditors must file a proof of claim in a Chapter 7 bankruptcy if there are assets and will be a distribution.

Reviewing the schedules is a good opportunity for a creditor to review the debtor's complete financial picture. This will help decide whether the debtor has any chance of reorganizing successfully, whether there is any chance of a distribution for general unsecured creditors, or whether there will be sufficient cash flow to pay administrative claims for creditors doing business with the debtor post-petition.[75] This information can be helpful to a creditor later, if the bankruptcy is dismissed for any reason. A creditor may wish to obtain a copy of the schedules for this reason.

If there is a chance of a good distribution, a creditor is more comfortable working within the bankruptcy process and not trying to assert equitable lien or administrative expense status. This will reduce legal fees for the creditor and the debtor, increasing the chances of a good distribution. If there is no chance of a distribution to general unsecured creditors, however, the creditor's only chance for payment will be to establish mechanic's lien, trust fund, equitable lien, administrative expense or other priority status.

No Notice of Bankruptcy

What if you did not receive notice of the bankruptcy? This may be because the debtor used a bad address for you or because of problems with the mail. It may also mean that the debtor did not list you as a creditor on the debtor's schedule of assets and liabilities.

If you are not listed as a creditor on the debtor's schedule of assets and liabilities, it will be necessary to file a proof of claim in the bankruptcy to share in any distribution to general unsecured creditors. A secured creditor, however, will not generally lose any rights in security property, even if they fail to file a proof of claim.[76]

A creditor that receives no notice of the bankruptcy will technically be unaffected by the bankruptcy. As a practical matter, however, this will rarely be helpful.

If a corporate debtor is liquidating in bankruptcy, the distribution to creditors in the bankruptcy will be the only chance to collect anything. After the bankruptcy, the corporate debtor will have no assets and will simply be out of business. In a Chapter 11 reorganization, a creditor not on the schedules and not filing a proof of claim will not be included in the plan.[77]

If an individual files a Chapter 7 bankruptcy, an unlisted creditor that did not receive notice of the bankruptcy may technically be able to sue the debtor for the full amount of the debt after all other debts have been discharged and the bankruptcy is closed. If this was a "no assets" bankruptcy that resulted in no distribution, however, courts have allowed the debtor to reopen the bankruptcy later to add the unlisted creditor and obtain a discharge from that debt.[78]

The bottom line is that it is generally better for creditors to participate in the bankruptcy process and file a proof of claim, even if they were not originally listed as a creditor and did not receive notice of the bankruptcy.

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[74] 11 U.S.C. §1111(a).

[75] *See* section below, Doing Business with the Debtor; subsection, Administrative Expense Priority.

[76] *Johnson v. Home State Bank*, 501 U.S. 78 (1991).

[77] 11 U.S.C. §1141(d); *In re Maya Construction*, 78 F.3d 1395 (9th Cir. 1996).

[78] 11 U.S.C. §350(b); FRBP Rule 5010; *Stark v. St. Mary's Hospital (In the Matter of Stark)*, 717 F.2d 322, 324 (7th Cir. 1983).

THE BANKRUPTCY PROCESS

Getting on the Mail List

If you received notice of the bankruptcy, then you were listed as a creditor on the schedule of assets and liabilities. As a listed creditor, you are also entitled to notice of meeting of the creditors, notice of dismissal of the bankruptcy or notice of discharge.[79] You will not, however, receive notice of many other proceedings in the bankruptcy, unless you file a Rule 2002 Request for Service of Papers shown in the Appendices.

Once you file a request for service, you will receive copies of everything that occurs in the bankruptcy. This is both good news and bad news. You will be aware of everything in the bankruptcy that may help you or may hurt you. You will have an opportunity to object to anything you think may hurt your ability to collect.

Receiving notice of all proceedings, however, means that you will receive many notices, motions, objections and other proceedings. Someone has to sift through all of this to determine whether any of it impacts you. This will mean legal fees if you have an attorney file a Notice of Appearance by Counsel and Request for Service of the Papers for you.

This will also mean a large volume of paper, which must be stored somewhere. Fortunately, most bankruptcy courts use electronic filing. This saves a lot of space and speeds the process, but someone still must review all notices to make sure your interests are protected.

Remember that bankruptcy is essentially the same as lawsuits filed at the same time by everyone doing business with the debtor. Everyone that has done business with the debtor is filing a proof of claim, filing motions to foreclose on security property or filing motions for payment of administrative expenses. The debtor must file a motion to hire a lawyer, to pay any creditor or to settle any claim. All of this means many notices and motions to review.

If you are satisfied to be a general unsecured creditor and do not expect a distribution, you probably do not want to file a Rule 2002 request for papers. Simply file your proof of claim and close your file. You will receive notice if there is any objection to your proof of claim.[80] If you are owed a large sum of money, however, you will need to get counsel to keep track of the bankruptcy. You want to object if the debtor is engaging in diseconomic behavior, if secured or unsecured creditors are overreaching and generally to maximize the eventual distribution to general unsecured creditors. You will also want to watch whether the debtor assumes a contract with you or any upstream contractors on a project to which you supplied labor and materials.[81] If you are claiming mechanic's lien, trust fund or equitable lien rights, you must respond if any secured creditor is claiming an interest in the same funds.[82]

It is a common problem that creditors never receive notice of bankruptcy or that subsequent notices during the bankruptcy process are sent to a bad address. A creditor can send two communications to the debtor containing a current account number and creditor address for correspondence. If two such notices are sent to the debtor in the first 90 days of the bankruptcy, then the debtors are required to send further notices to the creditor at that address and include the account number.[83]

It is also possible for any creditor to file a notice of address with any bankruptcy court that then has to be used by *any* bankruptcy court in any Chapter 7 or 13 bankruptcy.[84] Most creditors should consider filing such a notice with their local bankruptcy court for all of their accounts to make sure that bankruptcy notices go to the proper credit managers of the creditor.

A monetary penalty for violation of the automatic stay cannot be charged against a creditor for actions taken before the creditor receives notice of the bankruptcy.

The Meeting of Creditors

The Notice of Bankruptcy (in the Appendices) you received probably also gave a date, time and location for the "meeting of creditors." What is this meeting of creditors? Do you need to go? Do you need to have an attorney attend for you? Generally, no decisions will be made at the meeting of creditors that will prejudice you. It is an opportunity, however, to ask the debtor questions and collect information.

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[79] FRBP Rule 2002.

[80] 11 U.S.C. §502(b).

[81] *See* section below, Doing Business with the Debtor in Bankruptcy; subsection, Assumption or Rejection of Executory Contracts.

[82] *See* section below, Adversary Proceedings; the multiple chapters on Virginia, Maryland, Pennsylvania and D.C. Mechanic's Liens, etc.; the chapter, Trust Fund Laws and Agreements; the chapter, Equitable Remedies.

[83] 11 U.S.C. §342.

[84] 11 U.S.C. §342(f).

The meeting of creditors normally takes place at the U.S. Trustee's office. There may be many meetings scheduled for many different bankruptcies at the same time. The debtor must attend. The U.S. Trustee will be present.

Any creditor has the opportunity to ask the debtor about assets and liabilities, transactions or any possible fraudulent activity. A creditor can ask the trustee to compel the production of documents and other information.

The trustee operates something like a justice of the peace. The trustee will protect the debtor if necessary but will also make sure that the debtor complies with all rules. It is the trustee's job to protect the bankruptcy estate assets in order to maximize the distribution to the pool of general unsecured creditors. In other words, it may not matter whether you as an individual creditor have been hurt, but rather whether the pool of creditors as a group has been hurt.

The trustee will help creditors both at and after a meeting of creditors, but there must be a "complainant" or someone bringing problems to the trustee's attention. If you are aware of assets that the debtor did not list on schedules, the trustee will almost certainly require the debtor to produce documents about these assets. If you think a debtor has committed a fraud, the trustee probably will also compel the debtor to produce information. The trustee could, for example, require the debtor to produce copies of tax returns or bank account statements.

Normally, there are limits to the time a trustee will expend in any one case. A Chapter 7 trustee is normally a private attorney paid a nominal flat fee and a percentage of money brought into an estate. Accordingly, it is normally difficult for a trustee to justify spending much time on the case. In a Chapter 11, the U.S. Trustee is usually involved. They may not be so concerned about profitability, but are still trying to handle a large volume of cases.

You have the opportunity to ask the debtor questions about their business or financial matters. Meetings are usually recorded and transcripts can be ordered, but you will want to check on this in advance if it is important.

Whether you should go to a creditor's meeting, or have counsel attend, depends on your interest in the bankruptcy. If you are a relatively small, general unsecured creditor, there is no reason you have to attend. Nothing can happen at the meeting that will impact your rights. On the other hand, if you are a larger creditor, this is a good opportunity to collect information. This is particularly important if you believe the debtor committed a fraud upon you or you have another objection to discharge. Your objection to discharge must be filed within 60 days after the meeting of creditors, so this may be your only opportunity to collect information.[85]

Objection to Discharge

A creditor generally must file any objection to a discharge from debts within 60 days after the meeting of creditors, although you should also check the notice of bankruptcy carefully for a different deadline for objection. There are generally two types of objections to discharge.

Discharge of a Specific Debt

A §523 objection generally involves fraud on one particular creditor, resulting in no discharge on that particular debt. This type of objection has great advantages for a creditor. The debtor will be discharged from all other debts. This one creditor can pursue the debtor after the bankruptcy is concluded. This creditor will have a better chance of collecting in full.

An individual debtor is not discharged from any debt for money, property, services or credit obtained by:

a. False pretenses, a false representation or actual fraud (other than a statement concerning the debtor's financial condition), or
b. The use of a statement in writing concerning the debtor's financial condition that is materially false, that the debtor made with intent to deceive, and on which the creditor reasonably relied.[86]

Generally a debt is nondischargeable if the debtor obtained money though fraudulent statements, whether the statements were verbal or written. There is a special rule, however, for statements concerning "financial condition."

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[85] *See* section below, The Bankruptcy Process; subsection, Objection to Discharge.

[86] 11 U.S.C. §523.

A debtor can make false verbal statements concerning its financial condition and still receive a discharge but not false written statements.[87] This is a reason why creditors should require written financial statements or credit applications regularly. A debtor can obtain a discharge if he falsely stated verbally that he is solvent and has plenty of money to pay the debt. The debtor could not obtain a discharge if he stated that he was licensed and bonded, if this is not true.

A creditor will have the same problems with a §523 objection that exist in any fraud case. The creditor must prove that the debtor intended to deceive, must prove that the creditor actually relied on the deception, and must prove that the fraud actually caused damage. Mere promises to pay, however stupid, are not fraudulent. The debtor did not intend to deceive. False statements made after materials are shipped are not fraud, because the creditor did not rely on these statements to extend credit. False statements made to someone else will rarely be fraud, because the creditor could not have relied on these statements. Proving that the debtor is bad generally, and made many false statements will not prove fraud unless the creditor can prove the debtor made a specific statement in order to deceive this specific creditor and that the creditor actually relied on that statement in extending credit. As discussed below, however, proving that a debtor is bad generally may be a §727 objection, resulting in denial of any discharge from all debts.

Section 523 objections also exist to deny a discharge for alimony, child support, student loan repayments, injuries caused when driving while intoxicated, certain taxes or other governmental claims. These sorts of objections normally do not exist in a commercial context and are not the subject of this outline.

Discharge of the Debtor

A §727 objection means that the debtor is "generally bad," should not be allowed to use the bankruptcy process at all and should not receive a discharge at all.

Section 727 objections to discharge occur only in individual Chapter 7 cases and liquidating Chapter 11 bankruptcies. A corporation reorganizing under Chapter 11 cannot be denied a discharge under §727; rather, in a corporate Chapter 11 all debts of the corporation arising before the date of confirmation are discharged upon confirmation of the plan of reorganization.[88] Thus, the court can deny a corporate debtor under Chapter 11 a discharge by refusing to confirm a plan of reorganization that is not offered in good faith. Corporations cannot obtain a discharge in Chapter 7, so there is no need to object. Individuals can obtain a discharge in Chapter 13 from debts that would not be dischargeable in Chapter 7. Individuals in a Chapter 13 are required to make payments under a three-year plan that may be extended for cause for up to five years.[89]

Any creditor or the U.S. Trustee can file a §727 objection if the debtor:

1. Has received a bankruptcy discharge in the last six years
2. Has transferred, removed, destroyed, mutilated or concealed property in the last year
3. Has concealed, destroyed, mutilated, falsified or failed to keep books, documents, records or papers concerning financial conditions or business transactions
4. Has dealt improperly with the court, including making a false oath on an account, presenting a false claim or withholding books, documents or other records relating to the debtor's property or financial affairs, or failed to obey orders of the court.

If the court denies the debtor a discharge under §727, the debtor cannot obtain a discharge at all from any debt. Once the bankruptcy has been dismissed, all creditors will be able to pursue the debtor for collection. The problem is that an objecting creditor cannot appropriate all benefit to itself. *All* creditors will be able to pursue the debtor. The debtor's liabilities probably exceed their assets, or the debtor would not have filed bankruptcy to start with. Any individual creditor will have difficulty collecting. Also, the types of debtors that engage in bad behavior resulting in discharge denial are usually willing to engage in more bad behavior and make it even harder to collect. Still, a creditor may want to pursue a §727 objection to gain some satisfaction or to help police abuse of the bankruptcy process.

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[87] *See Collier on Bankruptcy* §523.08[2][1] (15th Edition Revised, Mathew Bender 2001); *In re Orphang*, 827 F.2d 340 (8th Cir. 1987).

[88] 11 U.S.C. §1141(d)(1).

[89] 11 U.S.C. §1322(d).

Objection to Exemptions

Similarly, a creditor must object within 30 days after the conclusion of the meeting of creditors to any exemption the debtor has claimed on any property. Exemptions involve only individual debtors and generally do not concern commercial creditors such as construction material suppliers. Exemptions could be an issue, however, when dealing with a sole proprietorship or when attempting to collect on a personal guaranty.

This outline will not deal in depth with exemptions. Generally, however, an individual debtor can "exempt" certain property from the bankruptcy estate. Exempt property is not available for distribution to creditors.

The debtor may exempt property that is exempt under federal *or* state *or* local law, if the debtor was domiciled in the state or locality for 180 days immediately preceding the bankruptcy petition. Some states, such as Florida, allow the exemption of the debtor's principal residence, no matter what the value. This results in some abuse, with some debtors moving to Florida, putting all of their available assets into the acquisition of a valuable personal residence, waiting 180 days and then filing bankruptcy.[90]

In any state a debtor can exempt certain property from the reach of the bankruptcy trustee and its creditors. The Bankruptcy Code has set up standard federal exemptions as shown below. In addition, state legislatures have the opportunity to opt out of the federal exemption scheme in favor of their own.[91] This has caused most states, including Virginia, to opt out of the federal exemption scheme, while some have chosen to adopt the federal exemptions. Still others allow debtors to choose from the state or federal exemption scheme. As a result, great diversity exists in the assets a debtor can protect in different states.

In any state, a debtor can exempt property held as tenants by the entirety or joint tenants, if the property would have been exempt from the debts of the debtor under state law.

In states following the federal exemption scheme the debtor may also exempt:

1. Up to $16,150 in a residence
2. Up to $2,575 in a motor vehicle
3. Up to $8,625 in household furnishings, household goods, wearing apparel and other items for personal or household use
4. Up to $1,075 in jewelry
5. Up to $1,625 in professional books or tools used in the debtor's trade
6. Life insurance contracts
7. Social Security benefits, unemployment benefits, veteran's benefits, disability benefits, alimony or support payments "to the extent reasonable necessary" and certain pension, profit sharing, annuity or other plans
8. Payments received because of certain life insurance contracts, personal injury awards or wrongful death awards.[92]

The Creditors' Committee

Very early in many Chapter 11 bankruptcies, a "creditors' committee" will be chosen. It is the committee's job to watch out for the best interests of the bankruptcy estate and the pool of unsecured creditors generally. The committee tries to maximize the eventual distribution to general unsecured creditors by keeping an eye on the debtor, the operation of the debtor's business and assets; by making sure secured creditors do not over reach or claim too many assets; by watching the bankruptcy process generally; and by making sure the debtor does not waste assets. The committee will also prosecute preference actions against other creditors, try to collect the debtor's receivables and other assets, collect on loans to principals or other "insider" transactions.

The committee's work is extremely important and someone must do it. It is, however, very much like being president of your local homeowners' association. While it is very important and you will benefit as a homeowner, it involves a lot of thankless work that will benefit a large group of people.

If you are one of the largest general unsecured creditors, it is very important to participate. The committee will have more influence than any one creditor over the conduct of the debtor and the bankruptcy process. The committee will normally hire an attorney to represent all of the general unsecured creditors. This is an expense of the bankruptcy

[90] 11 U.S.C. §522; *Smith v. Wellberg* (*In re Wellberg*), 12 B.R. 48 (Bankr. E.D.VA 1981).

[91] 11 U.S.C. §522(b)(1).

[92] 11 U.S.C. §522(d).

estate. The bankruptcy estate essentially hires an attorney at its expense to protect your interest. If you are one of the largest unsecured creditors and expect a large percentage of any distribution you should participate on the creditors' committee.

Creditors' committees are not always appointed. In Chapter 11 cases a creditors' committee can be formed soon after the bankruptcy petition and order for relief.[93] A Chapter 11 creditors' committee ordinarily consists of willing participants that hold the largest claims against the debtor.[94]

In a Chapter 7 liquidation, creditors may elect a creditors' committee at the Section 341 Meeting of Creditors. Normally, there is no creditors' committee in a Chapter 7, however. A Chapter 7 committee may be not have fewer than three and not more than 11 creditors.[95]

The Chapter 11 creditors' committee is chosen by the U.S. Trustee's office. The debtor must file a list of its 20 largest unsecured creditors with the bankruptcy petition. The U.S. Trustee will mail or fax acceptances to some or all of the 20 largest unsecured creditors, asking whether they are willing to participate. These acceptances should be returned promptly if you wish to be on the creditors' committee.

You must be a general unsecured creditor in order to be on the committee. A creditor claiming a security interest in property, trust fund or equitable lien rights or mechanic's lien rights probably will not qualify. Secured creditors have a conflict of interest with the creditors' committee.

The U.S. Trustee has the sole power to appoint members of the creditors' committee in Chapter 11 reorganization. This would normally happen very quickly, because the U.S. Trustee wants a creditors' committee in place to help manage the bankruptcy. Creditors' committee members are normally limited to the largest general unsecured creditors.

The court does have the power to change the membership of the creditors' committee on request, if the court determines that the change is necessary to ensure adequate representation of creditors.[96]

The court can also add a creditor that is a small business concern, if the creditor's claim is "disproportionately large" in comparison to the annual gross revenue of that creditor. This allows a small creditor to join the creditors' committee if the bankruptcy will have a large financial impact on that creditor.

Creditors' committees have responsibility to provide information to creditors not on the committee. The committee must provide access to information and must solicit and receive comments from general unsecured creditors not on the committee.

The Trustee

The U.S. Trustee is a full-time employee of the U.S. government. The U.S. Trustee has an important role in *every* bankruptcy, making sure that all cases are administered fairly and efficiently. The U.S. Trustee may raise any issue in any bankruptcy case.[97]

In a Chapter 7 bankruptcy, a case specific "Chapter 7 Trustee" will also be appointed. A Chapter 7 Trustee or a Chapter 11 Trustee is normally an experienced private attorney appointed to a trustee panel by the bankruptcy court. The U.S. Trustee will appoint the Chapter 7 Trustee from the panel but will still oversee the activities of the Chapter 7 Trustee. If no other case specific trustee is appointed, the U.S. Trustee is allowed to fulfill all trustee duties, but this scenario is unusual.[98]

In a Chapter 11 reorganization, by definition, the debtor's objective is to continue in business. There are obvious efficiencies in allowing the debtor to continue to run his or her own business. Normally, a Chapter 11 debtor continues to possess and operate the business as a "debtor in possession." A debtor in possession has all the rights and duties of the trustee.[99] At any time, however, the U.S. Trustee, a creditor or any other party in interest can request the appointment of a Chapter 11 Trustee to take over control of the business from the debtor in possession.[100] The bankruptcy court shall order the appointment of a Chapter 11 Trustee for cause, including fraud, dishonesty,

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[93] 11 U.S.C. §1102(a).
[94] 11 U.S.C. §1102(b).
[95] 11 U.S.C. §705.
[96] 11 U.S.C. §1102(a).
[97] 11 U.S.C. §307.
[98] 11 U.S.C. §321.
[99] 11 U.S.C. §1107(a).
[100] 11 U.S.C. §1104(a).

incompetence or gross mismanagement, *or* if the appointment of a trustee is in the interest of creditors, shareholders and other interests of the estate.[101] The court could also leave the debtor in possession in place, but appoint an Examiner to investigate the past or present management of the estate.

The trustee in any case is the representative of the estate.[102] This is similar to the role of the executor under a last will and testament when someone passes away. The executor under a will *is* the person that died for all purposes until the estate is closed. The executor collects all money due to the decedent, tries to pay all creditors to the extent possible, and distributes anything left over to the beneficiaries. Similarly, the bankruptcy trustee has the capacity to sue and be sued on behalf of the bankruptcy estate.[103] The trustee can run the business of the bankrupt debtor[104] and hire attorneys, accountants, appraisers and other professionals to assist.[105]

A trustee is almost always appointed in Chapter 7 liquidation. Promptly after a bankruptcy filing, the U.S. Trustee will appoint an interim trustee.[106] A permanent Chapter 7 Trustee can be elected by the creditors at the §341 meeting of creditors, but this procedure is rarely employed.[107] Normally, the interim trustee becomes the permanent Chapter 7 Trustee, assuming there is no conflict of interest and no election takes place at the meeting of creditors.[108]

The bankruptcy court can authorize the Chapter 7 Trustee to operate the business of the debtor for a limited period if this is in the best interest of the estate and consistent with the orderly liquidation of the estate.[109] In any event, the Chapter 7 Trustee is required to:

1. Collect and liquidate all property of the estate
2. Close the estate expeditiously
3. Be accountable for all property received
4. Investigate the financial affairs of the debtor
5. If a purpose would be served, examine creditor proofs of claim and object to improper claims
6. If advisable, oppose the discharge of the debtor
7. Furnish information about the estate to any creditor or other party in interest
8. File periodic reports on the operation of the debtor's business, if the trustee is operating the business, including a statement of receipts and disbursements
9. Make a final report and file a final account of the administration of the estate.[110]

The duties of the Chapter 11 Trustee (or debtor in possession) are to:

1. Be accountable for all property received
2. If a purpose would be served, examine creditor proofs of claim and object to improper claims
3. Furnish information about the estate to any creditor or other party in interest
4. File periodic reports on the operation of the debtors business, including a statement of receipts and disbursements
5. Make a final report and file a final account of the administration of the estate
6. File any required tax returns
7. As soon as practicable file a reorganization plan, report why a plan will not be filed or recommend conversion of the case to a Chapter 7 or a dismissal
8. After confirmation of a plan, file reports as necessary.

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[101] 11 U.S.C. §1104(a).
[102] 11 U.S.C. §323.
[103] 11 U.S.C. §323.
[104] 11 U.S.C. §721; 11 U.S.C. §1108.
[105] 11 U.S.C. §327.
[106] 11 U.S.C. §701(a).
[107] 11 U.S.C. §702.
[108] 11 U.S.C. §702(d).
[109] 11 U.S.C. §721.
[110] 11 U.S.C. §704.

Either the Chapter 11 Trustee or the debtor in possession has all of the duties above. If a trustee replaces the debtor in possession, that Chapter 11 Trustee must also:

1. File a list of creditors, a schedule of assets and liabilities, a schedule of current income and expenditures and a statement of the debtor's financial affairs (if the debtor has not already done so)
2. Investigate the acts, conduct, assets, liabilities and financial condition of the debtor; the operations of the debtor and the desirability of the continuance of such business; and then file a report on any such investigation.[111]

The trustee or debtor in possession is authorized to operate the business of the bankrupt and may enter into transactions in the ordinary course of business without any court hearing.[112] This includes the right to incur and pay post-petition debts in the ordinary course of business without prior approval of the bankruptcy court.[113]

DOING BUSINESS WITH THE DEBTOR IN BANKRUPTCY

Can You Be Forced to Do Business with the Debtor?

You cannot be forced to enter into a new contract with a debtor in bankruptcy. If you have completed all existing contracts with the debtor, you are free to simply decide you do not want to do any further business with the debtor.

If you are a true open account supplier, you are also free to discontinue doing business. If you have no set contract, proposal or quote with a specific quantity or duration, the debtor is not obligated to buy material from you. The debtor is free to call any of your competitors for material on any given day. You also have no obligation to supply material on any given day. Each time the debtor telephones or appears at your office constitutes a new separate contract for the purchase of materials. If you are such an open account supplier, you are free to decide at any time that you do not wish to enter into any new contracts with the debtor or supply any additional materials, whether or not the debtor is in bankruptcy.[114]

On the other hand, you could have a set contract with the debtor to supply a certain amount of materials over a certain period of time. Perhaps you sent a proposal to the debtor to supply all of the material necessary for a certain construction project. Similarly, you may have agreed to supply all the material the debtor needed for this entire year at set prices. If the debtor accepted this proposal or quote, you are no longer an open account supplier. Whether the debtor is in bankruptcy or not, you have an obligation to supply the materials described in your contract until the contract has expired. This is an "executory contract," discussed further below.[115]

An equipment supplier can also be on an open account basis and free to demand the return of equipment at any time. The same equipment vendor, however, might have entered into a one-month or one-year lease on the equipment. The equipment vendor in this case cannot demand return of the equipment, unless the debtor is in default on the lease. The vendor has committed to lease the equipment for one year and the debtor has the right to keep the equipment as long as rentals are current. This is also an executory contract.

An existing contract with the debtor that is not yet complete or has not yet expired is an "executory contract."[116] If you have an executory contract with a bankrupt debtor, you may be required to complete your contract. The debtor may even be able to assign the contract and you can be forced to do business with some new entity not of your choosing. On the other hand, you may be able to require "adequate assurance" that the debtor or this new entity will be able to perform their side of the contract.[117] Also, if you are required to complete a contract, then the debtor must "cure all default." You essentially become a preferred creditor, receiving payment in full for both pre-petition and post-petition debt. This is discussed in greater detail below in the section on executory contracts.

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[111] 11 U.S.C. §1106.
[112] 11 U.S.C. §1108.
[113] *In re Funding Systems Asset Management Corp.*, 72 B.R. 87 (Bankr. W.D. Pa. 1987).
[114] Uniform Commercial Code, Article 2, Section 2-309(2).
[115] *See* subsection below, Assumption or Rejection of Executory Contracts.
[116] *Black's Law Dictionary* (6th Edition, West Publishing 1990).
[117] 11 U.S.C. §365(b); 11 U.S.C. §365(f)(2).

Do You Want to Do Business with the Debtor?

If you have no "executory" or existing incomplete contract with the debtor, you cannot be forced to do business with the debtor. Some debtors will try to imply otherwise in convincing you to continue business, but this usually comes down to policy arguments and not any legal requirement on your part.

A debtor may say that they have no chance of a successful reorganization if vendors will not continue to supply material. The debtor's employees will lose their jobs and the general unsecured creditors will not receive any distribution if the debtor is forced to go out of business now. These may all be true statements, but they do not constitute a legal requirement on your part to continue doing business. The world as a whole may be better off if you continue to supply labor or materials to the debtor, but you as a creditor need to make your own decisions about the financial health of this particular debtor, the chances of receiving payment, the chances of a successful reorganization of the debtor and your chances of a long-term business relationship.

By definition, a debtor in bankruptcy is a business that had serious problems. Their liabilities probably exceed their assets. In any event, they were insolvent and not paying their debts as they became due. This is usually at least partly because of management problems. There may also be overriding economic or market conditions that make this business less profitable than it used to be.

No matter what caused the insolvency, bankruptcy will not usually make things better and is guaranteed to make some things worse. If nothing else, the bankruptcy adds large additional costs to the business. There are large legal fees for bankruptcy lawyers and accounting fees to create schedules and operating reports. In many ways bankruptcy is much like everyone filing suit against the debtor simultaneously. Most creditors will file papers in the bankruptcy to protect their interest. The debtor must often respond, generating more legal fees. Meanwhile, many of the debtor's customers are now very leery of doing new contracts with the debtor. This certainly impacts the debtor's business and lowers revenue. At the same time, the debtor's vendors are also leery of doing business and usually increase prices, require security or other concessions.

After bankruptcy, revenues usually fall further and expenses go up for a company that was already insolvent. This adds up to an extremely difficult task for any business to successfully reorganize in a bankruptcy. Why would anyone want to do business with a debtor in bankruptcy?

Most vendors will agree to continue to supply any customer that has a reasonable chance of successfully reorganizing. Otherwise, a vendor is simply opening the door and inviting their competitors into a market. Vendors can often charge premiums to do business with a bankruptcy estate and require payment in advance or other security. In other words, this can be very profitable business.

A vendor's initial reaction is often to refuse further business, unless and until pre-petition debt is paid. This stance is often short sighted. This pre-petition debt is already "gone." There is nothing anyone can do about this now. The only question for the future is whether the vendor wishes to have some profitable business, protect their market and relationship with a potentially long-term customer. The only other choice is to allow a competitor to get this profitable business and cement a relationship with your customer, who may successfully reorganize and be in business for years to come.

Vendors must take care in doing business with a debtor in bankruptcy. Creditors must evaluate the chances of a successful reorganization and whether there is enough cash flow to pay post-petition obligations. If a vendor can be reasonably sure of payment, then a vendor will normally want to do business.

Administrative Expense Priority

If you have no existing contract with the bankruptcy debtor and you voluntarily agree to extend credit by doing business with the debtor, you have a very high "administrative expense" priority for repayment of that new credit. The trustee or debtor in possession is authorized to operate the business of a Chapter 11 debtor and can obtain unsecured credit and incur unsecured debt in the ordinary course of business. This debt is automatically allowable as an administrative expense.[118]

Post-petition creditors are granted administrative expense priority to encourage them to do business with the debtor post-petition. No one would do business with a debtor in bankruptcy otherwise. No reorganization would ever succeed. The public policy reasons for aiding business reorganization would be thwarted.

[118] 11 U.S.C. §364(a).

The administrative expense priority will lower the money available to distribute to general unsecured creditors. Continuation or reorganization of the business, however, might result in a bigger payout to general unsecured creditors. Even in a Chapter 7 liquidation, there may be more assets for distribution if the business is wound up in an orderly manner and the debtor can complete profitable contracts. A successful Chapter 11 reorganization can generate future profits for distribution to unsecured creditors, in addition to saving jobs. These are the difficult decisions facing bankruptcy trustees and creditor committees: whether to slam the doors and immediately liquidate, expend some funds in an orderly liquidation, or expend even more funds in an attempt to reorganize. In any event, the Bankruptcy Code recognizes the need to grant an administrative expense high priority to any creditor doing business with the debtor after the bankruptcy petition.

An administrative expense has priority over all unsecured nonpriority pre-petition debt. If the business has a steady cash flow, post-petition vendors will normally be paid in the ordinary course of business. Although a large amount of pre-petition debt may have made the debtor insolvent, this pre-petition unsecured debt will simply have to wait to the end of the bankruptcy for any distribution. The trustee or debtor in possession is free of this pre-petition debt for the purposes of moving forward.

Lawyers and accountants working for the bankrupt debtor have the same type of administrative expense priority.[119] These attorneys and accountants do not have a high priority for payment *because* they are attorneys or accountants. It is because they are extending credit to the bankrupt debtor post-petition for the actual necessary costs and expenses of preserving the estate.[120] A creditor supplying labor or materials post-petition has essentially the same administrative expense priority.

It is still necessary to be cautious in extending credit to a bankruptcy estate. If there is *no* cash flow, it will not matter how high the priority. An estate can be “administratively insolvent.” No one doing business with the debtor post-petition will be paid. Secured creditors may be entitled to eat up all cash flow that exists.[121] The business may fail, even free of the large pre-petition debt. In other words, it may be a bad decision to continue or reorganize a business that simply should have been liquidated immediately.

If the debtor’s bank agrees to reopen or extend new credit for the operation of the business, that bank may require “super priority.”[122] If the trustee is unable to obtain unsecured credit, the court may authorize the new credit with a super priority over administrative expenses. The debtor may obtain a new line of credit to continue the business and pay post-petition vendors. If things go as planned, this line of credit will help the debtor pay post-petition vendors in the ordinary course. If it goes badly, however, the lender of that new line of credit may be able to consume all of the available cash flow. Your administrative expense priority may still leave you unpaid.

The only way to completely eliminate these risks for new sales are to require cash in advance, cash on delivery, payment bonds or other security. If you have no existing executory contract with the debtor, you have no obligation to do business at all. By the same token, you have the ability to require payment in advance. If you have an executory contract with the debtor, you may be required to do business. As discussed below, you can require “adequate assurance” of payment before the debtor assumes your contract, if there has been a default. If you continue performance and extend credit in the ordinary course of business before the trustee actually assumes the contract, however, you will have simple administrative expense priority and may still have the risk described above.[123]

As discussed below in the subsection on Reclamation, a creditor can file for an administrative expense claim for any goods delivered within the 20 days prior to a bankruptcy petition.[124]

Assumption or Rejection of Executory Contracts

If you have an existing contract or lease with the debtor that is not yet complete or has not yet expired, this is an “executory contract.” Performance must remain due to some extent on both sides for a contract to be executory. A promissory note, for example, is not usually an executory contract. The only performance left is repayment. Performance on the lender’s side of the contract is already complete.

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[119] 11 U.S.C. §503(a)(4).

[120] 11 U.S.C. §503(b).

[121] 11 U.S.C. §507(b).

[122] 11 U.S.C. §364(c).

[123] 11 U.S.C. §364(a); *In re Ophang*, 827 F.2d 340 (8th Cir. 1987); *See Collier on Bankruptcy* §503.06[5][a][b] (15th Edition Revised, Mathew Bender 2001).

[124] 11 U.S.C. §503(b)(9).

A bankrupt debtor generally has the option to either "assume" or "reject" executory contracts and unexpired leases. If an executory contract is rejected, then the debtor has decided to breach the contract. The creditor has a pre-petition claim for all damages resulting from this breach or "rejection." Court approval is required in order to reject an executory contract or unexpired lease.

The debtor also has the option to "assume" executory contracts or leases. The debtor and the creditor have the obligation to continue performance. The debtor can even assume and then assign an executory contract or lease. The creditor is then forced to continue doing business with someone new.

A debtor can assume and assign an executory contract, even if the contract purports to prohibit assignment. Similarly, if a contract states that it is a breach of contract to file bankruptcy or become insolvent, the Bankruptcy Code removes this provision from the contract.[125]

Other than these specific contract provisions removed by the Bankruptcy Code, the debtor must "cure all default" in the contract or lease in order to assume or assign.[126] The creditor is entitled to the full benefit of the bargain in the contract. The debtor must cure all default and must provide adequate assurance of future performance.[127]

Debtors continuing in business after bankruptcy almost always want to continue utility services such as electricity. The Bankruptcy Code requires "assurance of payment" to a utility serving a debtor in the form of a cash deposit, a letter of creditor, a certificate of deposit, a surety bond, a prepayment or another form of security agreed to by the utility.[128] Bankrupt debtors will normally have difficulty obtaining a letter of credit, a certificate of deposit or a surety bond. Accordingly, most debtors desiring to continue utility services will probably need to post a cash deposit or prepay. A utility is allowed to alter, refuse or discontinue service 30 days after a bankruptcy petition if it does not receive adequate assurance of payment that is satisfactory to the utility. Utilities are also allowed to offset pre-petition debt against any security deposit held.

Creditors are often uncomfortable with a bankrupt debtor assuming and assigning an executory contract or lease. It is true that a creditor can be forced to do business with someone the creditor did not choose. On the other hand, this creditor becomes significantly preferred over almost all other creditors in the bankruptcy. All *pre-petition* debt must be paid. Even attorney's fees must be paid, if the contract or lease required payment of attorney's fees on default.[129] The creditor is entitled to adequate assurance of future performance, which could include security, payment bonds or even payment in advance.

In other words, the creditor can be no worse off as a result of the bankruptcy, assumption and assignment. In some respects, the creditor is better off. If the contract is not assumed then, the contract is rejected. The creditor will be a general unsecured creditor, unless the creditor independently had some type of security. This normally means a small percentage payout or no payment at all. Accordingly, creditors normally hope that their contracts and leases with a bankrupt debtor will be assumed.

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[125] 11 U.S.C. §365(b)(2).

[126] 11 U.S.C. §365(c); However, it is not necessary for a debtor tenant to cure *nonmonetary* defaults in order to assume a lease, if it is impossible to cure the default at the time of assumption.

[127] According to 11 U.S.C.§365(b):

If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of the assumption of such contract or lease, the trustee—

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly [**9] compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.

11 U.S.C. §365(b); "If the debtor is delinquent under the executory contract, the trustee must demonstrate to the court that he can cure the default and make future payments." *In re Superior Toy & Mfg. Co.*, 78 F.3d at 1172. The "language and intent" behind §365(b) is "decisive and unequivocal." *Id.* 1174. "A party to an executory contract must be paid all amounts due him under the contract before the contract may be assumed." *Id.* In drafting §365(b), Congress not only required the trustee to guarantee payment for future performance under the contract, *Id.*, it also "required that the trustee guarantee payment of all amounts owed prior to assumption." *Id.*

According to the House and Senate reports: "If the trustee is to assume a contract or lease, the court will have to ensure that the trustee's performance under the contract or lease gives the other contracting party the full benefit of his bargain." Senate Rep. No. 989, 95th Cong., 2nd Sess. 59 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5845; H.R. Rep. No. 595, 95th Cong., 2nd Sess. 348 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6304-05.

[128] 11 U.S.C. §366(c)(1)(A).

[129] A court will "generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed" by the Bankruptcy Code. *See Traveler's Casualty and Surety Co. v. Pacific Gas and Elec. Co.*, 127 S. Ct. 1199, 167 L. Ed. 2d. 178 (2007).

If an executory contract or unexpired lease is eventually assumed, then any payments received by that creditor in the 90 days prior to bankruptcy also cannot be a preference. These are payments that the debtor would have been required to pay anyway in order to cure all default. Accordingly, this creditor has not been preferred and has not received more than it would have under a Chapter 7 liquidation.[130] Obligations that are assumed are generally regarded as priority administrative expenses.

The debtor is required to file a schedule of executory contracts and unexpired leases early in the bankruptcy process.[131] In a Chapter 7 liquidation, all executory contracts and unexpired leases are deemed rejected 60 days after the bankruptcy, unless the debtor takes affirmative action to assume. The debtor can, however, request additional time to make that decision.[132]

In a Chapter 11 or Chapter 13, however, the debtor normally decides whether to assume or reject contracts in the plan of reorganization. In other words, the debtor will evaluate all executory contracts and unexpired leases, while evaluating the entire business. The debtor is not required to make a decision on assumption until the plan of reorganization is filed. One exception to this is *non*residential leases. If the debtor is a tenant in a shopping center, office or industrial park, for example, the nonresidential lease is deemed rejected if not affirmatively assumed within 120 days after the bankruptcy.[133] This deadline can be extended by the court for one (1) additional 90-day period, but this extension must be granted before the original 120-day period expires and must be for "good cause shown."[134] In any event, a creditor can ask the court to require the debtor to decide on assumption or rejection earlier than the normal deadlines.[135]

Lessees of personal property, including rental equipment must decide whether to assume or reject the equipment lease within 60 days of a bankruptcy petition. If the personal property lease is not assumed, it is deemed rejected.[136] The automatic stay automatically terminates if the debtor does not assume the lease within this time deadline.[137] This makes it easier for equipment rental vendors to retake possession of rental equipment sooner after a bankruptcy petition. If the debtor does assume the lease, of course, the debtor must "cure all default" and bring lease payments up to date.

It often frustrates creditors that bankrupt debtors have this much flexibility in dealing with executory contracts and leases. Creditors must remember, however, that this process is not a contest between the creditor and the debtor. Rather, the question is whether the group of creditors as a whole will be better off with rejection or assumption of a contract. The trustee or bankruptcy estate basically makes a business decision whether the executory contract is profitable. If so, the contract will be assumed and the profit generated will be available for distribution to creditors. This one creditor with the executory contract can be forced to continue doing business with the debtor, but has the advantage of being preferred over all other creditors and will be paid in full.

If the executory contract is unprofitable, the trustee or bankruptcy estate will reject. While this action will also certainly frustrate, it puts the creditor in no worse position than any other general unsecured creditor in the bankruptcy.

Critical Vendors

There has been much discussion and publicity about the role of "critical vendors" in bankruptcy. It is possible for a creditor to be named a critical vendor and receive payment for pre-petition debt.

Critical vendor status is relatively new. The standards, requirements and process are uncertain. The courts that have allowed critical vendor status have done so under Bankruptcy Code §105. This is a general "power of court" code section, stating that the court may issue any order that is necessary or appropriate to carry out the provisions of the Bankruptcy Code. In other words, the U.S. Congress and the Bankruptcy Code did not explicitly create critical vendor status or describe the policy or the process. This is a court-created concept.

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[130] *See* section below, Preferences; sub-subsection, Assumption of Contract.
[131] FRBP 1007(b)(1).
[132] 11 U.S.C. §365(d).
[133] 11 U.S.C. §365(d)(4).
[134] 11 U.S.C. §365(d)(4).
[135] 11 U.S.C. §365(d)(2).
[136] 11 U.S.C. §365(d).
[137] 11 U.S.C. §365(p).

It does make sense that a vendor could be absolutely critical to a business. This would have to be essentially a "sole source" vendor, however. There is no other way for the bankrupt business to survive, without doing business with this critical vendor.

If a vendor has any competitors in the market, by definition, they cannot be critical. The trustee (general pool of unsecured creditors) is essentially deciding whether to prefer one creditor over all other creditors. This is similar to the analysis of assumption of executory contracts. If there is enough future profit in an executory contract, the trustee will decide on assumption, even though the trustee must "cure" all default and prefer this creditor.

In a critical vendor analysis, the trustee, court and creditors committee is deciding whether to make a large lump sum payment to one vendor in order to preserve a source of supply. As a matter of basic business judgment, this will not make sense if the vendor has any competitors. Even if the estate must pay a premium to a competitor to purchase future materials, this is normally preferable to paying a large lump sum of pre-petition debt. By granting critical vendor status, the estate is removing a large sum of cash from the pool available for distribution to creditors in exchange for the hope of getting more profit later doing business with this vendor. The estate would normally rather pay a premium to a competitor with each purchase in the future. In this way, the estate has not expended extra money unless and until it is doing new business.

A creditor interested in critical vendor status should normally start by communicating with the debtor about creating this "partnership." If the debtor does not think it is a good business arrangement to prefer this creditor, the vendor is probably not critical. If the debtor is in favor of the idea, it must be sold to the creditors' committee. Again, the creditors' committee is deciding whether it is good business judgment to let go of cash reserves now in order to get future supplies from this vendor. If the creditors' committee is in favor, it is appropriate to seek bankruptcy court approval. The court must, of course, be convinced that preferring this vendor as critical is a good business decision that will result in greater profits long term. *Any* creditor in the bankruptcy could object. This would likely be the competitor who is willing to do business with the debtor without payment of pre-petition debt. If this competitor can supply the same product, it would make sense for the bankruptcy court to deny critical vendor status.

MOTIONS

Activity in bankruptcy cases is split into "adversary proceedings," "motions," "applications" and "contested matters." The distinction and differences are largely procedural. Lawyers must be very careful to structure their activities in the correct form. Business people are less concerned, as long as they have a good lawyer. Regardless, it is good to have a basic understanding of these concepts.

Motion for Relief from the Stay

As discussed above, the automatic stay prohibits any creditor from taking aggressive action against the debtor after bankruptcy. A creditor must file a "motion for relief from the stay" in order to get permission to take various actions.

The debtor and any other party have an opportunity to object to the motion for relief from the stay, then the court considers the motion on an expedited basis. The court can deny the motion and leave the automatic stay in place or grant the motion.

In general terms, a creditor is entitled to relief from the stay only if it can show: (1) good cause, including lack of adequate protection for the creditor, or that (2) the debtor does not have equity in the property and it is not necessary to an effective Chapter 11 reorganization.

There are some limits on the automatic stay for "serial filers," that is debtors that repeatedly file bankruptcy petitions. Most of these provisions concern consumer bankruptcies, but some are also applicable to commercial debtors.

In small business cases, the automatic stay does not apply if a debtor was in another small business case bankruptcy that was dismissed or had a final reorganization plan confirmed in the two years prior to the current bankruptcy petition.[138]

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[138] 11 U.S.C. §362(n).

Debtors sometimes repeatedly file bankruptcy in order to stop imminent foreclosures. Mortgage lenders in such cases often obtain bankruptcy court relief from the stay; debtors allow their bankruptcy to be dismissed, only to file the bankruptcy again on the next eve of foreclosure. The automatic stay does not apply to a mortgage lender if the lender had received a bankruptcy court order terminating the automatic stay in any bankruptcy within the prior two years.[139] The bankruptcy court can also enter an order prohibiting a debtor from filing any further bankruptcies. The automatic stay will not apply if the debtor does file again.[140]

In an individual bankruptcy, the automatic stay will generally automatically terminate after 30 days if the debtor had a prior bankruptcy dismissed in the last year.[141]

Foreclosing on Property or Repossessing Equipment

Secured creditors often bring a motion for relief from the stay to foreclose or repossess property. In general terms, a court will allow a secured creditor to enforce its rights against security property, unless the creditor has "adequate protection." In other words, the creditor's position will not be damaged by the passage of time. A secured creditor can bring a motion for relief, in order to force the debtor to provide more protection to the secured creditor.

Even if there is adequate protection, a secured creditor can request relief from the stay if the debtor has no equity in the property *and* the property is not necessary for a Chapter 11 reorganization. Obviously, if you are in a liquidating bankruptcy, no property will be necessary for the debtor's effective reorganization. If the creditor's security interest is equal to or greater than the value of the property, then the debtor has no equity. This is often true with real estate and equipment.

Lessees of personal property, including rental equipment must decide whether to assume or reject the equipment lease within 60 days of a bankruptcy petition. If the personal property lease is not assumed, it is deemed rejected.[142] The automatic stay automatically terminates if the debtor does not assume the lease within this time deadline.[143] This makes it easier for equipment rental vendors to retake possession of rental equipment sooner after a bankruptcy petition. If the debtor does assume the lease, of course, the debtor must "cure all default" and bring lease payments up to date.

Complaint to Enforce Mechanic's Lien

In most states with an inchoate[144] mechanic's lien, a creditor is allowed to file a memorandum of mechanic's lien without relief from the automatic stay. In order to later file a lawsuit, petition or complaint to enforce mechanic's lien, however, the creditor must get relief from the automatic stay.[145]

Obviously, a bankruptcy cannot be concluded without determining the validity, priority and amount of liens claimed by all secured creditors. This includes mechanic's lien claimants. The mechanic's lien case must be decided either in the bankruptcy court or in the state court. Bankruptcy courts are normally reluctant to delve into the factually complicated disputes in most construction cases and do not want to become experts in state mechanic's lien law. Accordingly, most bankruptcy courts will grant relief from the automatic stay, so that the creditor can file a complaint to enforce mechanic's lien rights in state court. The state court will then make factual findings regarding the labor and materials supplied and legal rulings on the validity of the mechanic's lien.

Theoretically, the creditor is usually required to return to the bankruptcy court once the validity, priority and amount of the mechanic's lien has been established in state court. As a practical matter, however, the owners, lenders and title insurance companies normally want to settle the mechanic's lien case before it gets very far in state court. Accordingly, a mechanic's lien claimant must always obtain relief from the automatic stay to file suit, but often does not need to participate further in the bankruptcy process.

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[139] 11 U.S.C. §362(b)(20).

[140] 11 U.S.C. §362(b)(21).

[141] 11 U.S.C. §522(n).

[142] 11 U.S.C. §365(d).

[143] 11 U.S.C. §365(p).

[144] *See* chapter, Mechanic's Lien Rights and General Principles.

[145] *Graybar Elec. Co. v. Prop. Techs., Ltd. (In re Prop. Techs., Ltd.),* 263 B.R. 750 (Bankr. E.D. Va. 2001); *George W. Kane, Inc. v. Nuscope, Inc.*, 243 Va. 503, 416 S.E.2d 701 (1992); *H.T. Bowling, Inc. v. Bain*, 52 Bankr. 58 (W.D. Va. 1985), *aff'd in part and rev'd in part* 64 Bankr. 581 (W.D. Va. 1986); *See* the multiple chapters, Virginia, Maryland, Pennsylvania and D.C. Mechanic's Liens.

Termination of a Lease

The automatic stay prohibits any creditor from taking possession of any property from a debtor. A landlord, for example, cannot evict a tenant in bankruptcy without relief from the stay. The same is true of equipment leases. Even if a debtor has equipment on just a month-to-month or even day-to-day lease, the equipment owner cannot go pick the equipment up without getting relief from the automatic stay.[146]

Set-Off Rights

What if you owe money to a bankrupt debtor at the same time that debtor also owes you? You may supply materials to a carpentry subcontractor, who owes you a large sum on an open account. At the same time, you have hired the carpentry subcontractor to build you a new showroom.

The bankruptcy estate can bring a complaint against you to collect what you owe the debtor, but what about your receivable? Are you forced to pay the debtor in cash now for your pre-petition debt and then just hope there is a distribution later to general unsecured creditors to pay your pre-petition receivable?

A creditor is allowed to set-off a pre-petition payable and owed to the debtor against a pre-petition receivable owed by the debtor, however, no other combination is allowed. In other words, you cannot off set your post-petition obligation to the debtor against the pre-petition receivable still owed to you.[147]

Set-off rights are essentially a security interest.[148] You must remember to assert the set-off rights on your proof of claim.[149] You must also bring a motion for relief from the stay in order to actually set-off the monies. You can freeze money without relief from the stay, but must get relief before you start moving money.[150]

Deadline to Assume or Reject

If you have an ongoing contract or lease with a bankrupt debtor, the estate has the right to choose whether to "assume" or "reject" that contract or lease. This is discussed in greater detail above.[151]

You may want to force the debtor to decide whether to assume or reject. A creditor should be reluctant to extend new credit post-petition until a debtor has decided whether to assume or reject. A landlord may want to be free to re-lease a premise to a new tenant if the debtor is not going to cure all default and pay pre-petition arrearages.

A creditor can file a Motion to Compel Assumption or Rejection for this purpose. The bankruptcy court will decide whether the debtor has had sufficient time to evaluate its contracts and can set a deadline to assume or reject.

Payment of Administrative Expenses

After a Chapter 11 reorganization petition is filed, it is "business as usual." As discussed above, the debtor is free to incur trade debt in the ordinary course of business. This trade debt has a "high administrative priority."[152]

What if the debtor does not pay this administrative expense? You can file suit in the bankruptcy case in the form of "Motion to Compel Payment of an Administrative Expense." This is essentially a lawsuit against the debtor, similar to a collections lawsuit in state court.

ADVERSARY PROCEEDINGS

Adversary Proceedings or Complaints

An adversary proceeding is a separate, freestanding lawsuit. It starts with a "complaint," just the same as any federal lawsuit and most of the same federal rules of civil procedure apply. It is a lawsuit that had to be filed in this bankruptcy court, because it is related to a pending bankruptcy. Adversary proceedings often concern lawsuits to collect money, either by the debtor or from the debtor. Examples of adversary proceedings are:

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[146] *See Collier on Bankruptcy* §362.03[5][9] (15th Edition Revised, Mathew Bender 2001).

[147] 11 U.S.C. §553; *In re Passafiume*, 242 B.R. 630 (Bankr. W.D.KY 1999).

[148] 11 U.S.C. §506(a).

[149] *Davidovich v. Welton* (*In re Davidovich*), 901 F.2d 1533, 1537 (10th Cir. 1990) [creditor who has not filed proof of claim cannot use claims of set-off to obtain affirmative recover against estate]; *See Collier on Bankruptcy* §553.07[1] at fn. 11 (15th Edition Revised, Mathew Bender 2001).

[150] *Citizens Bank of Maryland v. Strumpf,* 516 U.S. 16 (1995).

[151] *See* section above, Doing Business with the Debtor in Bankruptcy; subsection, Assumption or Rejection of Executory Contracts.

[152] *See* section above, Doing Business with the Debtor in Bankruptcy; subsection, Administrative Expense Priority.

1. Preference actions[153]
2. Objection to a discharge or a dischargeability of a debt[154]
3. Actions to collect receivables or other property[155]
4. Any proceeding to determine the validity, priority or extent of a lien
5. Action to claim reclamation rights.

Reclamation Rights

The right to reclaim goods has always been important to creditors when a debtor files bankruptcy. A vendor with the right of reclamation becomes a secured creditor and may be able to retake possession of the goods sold. If there is no right of reclamation, the vendor is a general unsecured creditor.[156]

The right of reclamation has been a part of the Uniform Commercial Code (UCC), applicable in most of the United States.[157] The Bankruptcy Code has always generally respected the state law right of reclamation. Formerly, creditors could "reach back" to reclaim goods delivered within state law time limits, generally within 10 days of the bankruptcy. The Bankruptcy Reform Act of 2005 extended this to goods delivered within 45 days of the bankruptcy.

A vendor must still remember to provide the debtor written notice in order to have reclamation rights. That notice formerly had to be given within 10 days of delivery under the UCC. The Reform Act of 2005 extended this deadline. The creditor must provide the debtor written reclamation demand within 45 days from the debtor's receipt of the goods. Even if the creditor fails to provide the written reclamation demand in time, the creditor is still entitled to an "administrative expense claim" for any goods received by the debtor in the 20 days prior to the bankruptcy petition. Filing for an administrative expense claim provides the creditor a high priority in the bankruptcy that will normally result in payment.

In other words, a creditor can reclaim goods delivered within the 45 days prior to a bankruptcy petition, as long as written reclamation demand is delivered within 20 days after the bankruptcy petition.[158] A creditor can file for an administrative expense claim for any goods delivered within the 20 days prior to a bankruptcy petition in any event, regardless whether any reclamation notice has been sent.[159]

You must file an adversary proceeding to actually reclaim goods. You can and must send your notice of reclamation without relief from the stay.[160] However, you cannot pick up reclaimed goods without getting bankruptcy court approval in an adversary proceeding.

A creditor should be sure to send notice by some method providing third-party verification of receipt, such as commercial courier, Federal Express, certified mail or service by the sheriff. Otherwise, it will be difficult to prove receipt of written demand.

The UCC, however, also made an exception to the 10-day limitation where the buyer has made a misrepresentation regarding his solvency, in writing within three months prior to the delivery.[161] In such a case, the 10-day rule does not apply and the seller can reclaim even after the 10-day period has expired. For this reason suppliers should get a new financial statement from buyers that make them nervous. Seller simply can also get a written statement before delivery that "the buyer will be able to pay within agreed terms."

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[153] *See* section below, Preferences.

[154] *See* section above, The Bankruptcy Process; subsection, Objection to Discharge.

[155] *In re Catalanous*, 216 BR 159 (Bankr. D Md. 1997); *In re Ward*, 210 BR 531 (Bankr. E.D. Va.).

[156] 11 U.S.C. §546(c).

[157] *See* chapter, Uniform Commercial Code Sale of Goods; section, Contract Performance and Breach; subsection, Seller's Right to Reclaim Goods.

[158] 11 U.S.C. §546(c).

[159] 11 U.S.C. §503(b)(9).

[160] 11 U.S.C. §546(c).

[161] UCC 2-702. But when a buyer is in bankruptcy, the 10-day rule is not extended in the event of fraud, pursuant to 11 U.S.C. §546(c)(1); *See In re Oakland Gin Co., Inc. v. Marlow,* 44 F.3d 426, 432 n.4; *See also Collier on Bankruptcy* §46.04[2][b][iii] (15th Edition Revised, Mathew Bender 2001).

The right of reclamation is important in a buyer's bankruptcy. If the seller has made a reclamation demand, then the seller is in a superior position to unsecured creditors. This seller can simply reclaim and regain ownership of the goods. The bankruptcy court can deny a proper right of reclamation only by granting the reclamation claimant security with a lien or an administrative expense priority.[162] If no reclamation demand is made, then the seller has to stand in line with the rest of the creditors. The goods would be part of the bankruptcy estate. Under those circumstances, a seller is a general unsecured creditor and may not have a right to reclaim the goods, but may have an administrative expense claim, state law mechanic's lien or payment bond rights.

A secured lender with a floating lien on the debtor's assets will have superior rights to a reclamation claimant.[163] While the secured creditor's superior claim would not entirely defeat the reclamation claim, it would reduce the reclamation claim to a secondary lien.[164]

The key factor is that the buyer be insolvent at the time of receipt. No claim can be made if the buyer becomes insolvent after receipt of the goods. Also, if the seller knows that the buyer is insolvent and makes delivery anyway, the seller cannot reclaim the goods. Under the UCC, the right to reclaim goods is exclusive of all other remedies. A seller cannot also sue the buyer for damages.

If materials are supplied and then incorporated into a project, a seller cannot reclaim the materials. Title would have passed to the owner of the project or the property. Under these circumstances, a seller may also not have a right to reclaim the goods but may have an administrative expense claim, state law mechanic's lien or payment bond rights.

The UCC also allows a seller to refuse future deliveries of materials unless the buyer can give adequate assurances of payment for future deliveries and makes payment for all materials delivered up to that time. If the seller discovers buyer's insolvency, the seller can stop making deliveries or require cash in advance.[165]

PREFERENCES

Introduction

Your customer files bankruptcy, and you are burned for thousands of dollars. Your profit for at least a month is down the drain. You and everyone in your company work overtime for months to make up for the loss, but you get over it and move on.

Two years after the bankruptcy, you receive a letter demanding that you pay more money to the bankrupt debtor. Soon after that, your bankrupt customer files suit against you. What is going on?

Preference litigation has increasingly frustrated creditors. The preference law has been on the books for many years, but litigation was rare until the late in the twentieth century. Preference claims have become quite fashionable and can now be expected in almost every bankruptcy.

The Objective

Historically, the objective of preference law was to keep a bankrupt debtor from preferring friends, family and related entities instead of paying general creditors. Otherwise, an insolvent debtor could simply pay his brother's company in full and then file bankruptcy—and all other creditors would receive nothing. Modern commerce often has related entities doing business with one another, including parents, subsidiaries and companies with common shareholders. It would be a problem if an insolvent debtor could prefer these related creditors over others.

Another important objective of the Bankruptcy Code is to "stop the race to the courthouse."[166] If a debtor starts to get into financial trouble, we do not want creditors filing suit as soon as possible, in order to force a quick payment before the debtor files bankruptcy. We want creditors to work with debtors for the better good of all. If a creditor knows that payments received shortly before a bankruptcy must be repaid, then a creditor is more likely to work with a debtor toward an amicable resolution.

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[162] 11 U.S.C. §546(c)(2).

[163] *In re Rea Keech Buick, Inc.*, 139 BR 625 (MD 1992).

[164] UCC 2-403.

[165] UCC 2-609.

[166] *In re First Jersey Securities, Inc.,* 180 F.3d 504, 511 (3rd Cir. 1999).

To fix these problems, we just pretend that the debtor filed bankruptcy 90 days earlier than the actual petition date. Just like the automatic stay keeps creditors from advancing their position after bankruptcy, this 90-day preference period keeps a creditor from advancing their position in the 90 days prior to bankruptcy.

The paradigm shift necessary to understand bankruptcy is particularly important in the context of preference actions. The creditor is now being forced to pay money back to the same debtor that burned him for thousands already. It is particularly confusing that preference litigation is brought in the name of the bankrupt debtor. It is technically your defaulting former customer that is suing you for more money. This makes the process seem particularly unfair.

However, bankruptcy preference litigation is not a battle with the debtor. It is a battle between creditors. Why should one creditor end up being paid in full while other creditors are paid nothing? For that matter, why should one creditor end up with 50 percent of their receivable when other creditors end up with 10 percent? After bankruptcy, the "estate" is the pool of general unsecured creditors represented by the trustee. The debtor is gone, except in a salaried management role. The shareholder or equity holders do not own the company any longer. Secured creditors generally also stay out of the bankruptcy process. The process is primarily intended to protect the general unsecured creditors.

The Preference Mechanism

The preference law essentially pretends that bankruptcy was filed 90 days earlier than the actual petition date. Any advantage a creditor obtained during that 90-day "preference period" can be undone or "avoided." The preference law applies to any "transfer" of money, property or any interest in property.

The most common example is payments received. The operative date for this purpose is the date an ordinary check *cleared the debtor's bank*, not the date of the check or the date of receipt by the creditor.[167] Creditors can be at preference risk longer than they think, if the creditor holds checks for a long period of time or if checks travel out of state to a corporate lockbox for deposit.

The preference law can avoid a security interest, just the same as avoiding a payment. If a debtor transfers a security interest in all accounts receivable to one creditor and then files bankruptcy within 90 days, this security interest can be avoided as a preference. Accordingly, early planning is important for creditors to obtain consensual security agreements.

A judicial lien can also be avoided and is often the very cause of a bankruptcy filing. If a contractor sues a real estate developer and "wins" the case, the judgment lien will attach to all real estate owned by the developer in the county. If the developer files bankruptcy within 90 days, however, that judgment lien can be avoided. The creditor contractor has wasted months and thousands of dollars in legal fees for nothing.

When a garnishment is filed, the judgment lien actually attaches to the funds in a bank account. This lien can also be avoided by filing bankruptcy within 90 days. Garnishments are often the cause of bankruptcy by consumers and small business debtors.

The Perception Problem

While the theory behind preference law makes sense, the proliferation of preference litigation has exposed many problems.

The system generates large transaction costs, relative to the questionable benefit. Creditors that have already lost money dealing with this debtor are now spending more money defending preference claims and repaying preferences. Bankruptcy estates that are already badly overburdened with legal and accounting fees are now incurring more of both. The costs of handling this money may not be worth the benefit derived.

Many business professionals feel that lawyers are the only beneficiaries to this system. Indeed, preference litigation has made it more profitable to practice debtor bankruptcy law. The debtor filing bankruptcy chooses the lawyer or law firm to represent the debtor in bankruptcy. This generates a fee, often paid in advance. This lawyer then often represents the bankruptcy estate or unsecured creditors' committee for the purpose of pursuing preferences. If a case specific trustee is appointed, this is normally a private bankruptcy attorney that can and will hire other attorneys in the same firm to pursue preferences and other litigation. Many business professionals perceive this as a "cottage industry," with lawyers generating cases and then generating fees prosecuting these cases.

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[167] *Barnhill v. Johnson*, 503 U.S. 393 (1992) [the operative date for a certified or cashier's check is the date upon which it is delivered]; *Hallmark Elec. Corp. v. Sims*, 108 F.3d 239 (9th Cir. 1997); *In re Lee (in re Ota)*, 179 B.R. 149, 159 (B.A.P. 9th Cir. Cal. 1995) [date of receipt of a cashier's check by transferee is the effective date of transfer]; *In Re Barefoot*, 952 F,2d 795 (4th Cir. 1991) [receipt of a wire transfer is the effective date of the transfer]; *See Collier on Bankruptcy* §547.05[4][a] (15th Edition Revised, Mathew Bender 2001).

It is sometimes questionable whether there is any "client" reviewing the costs or benefits of this activity. In a normal commercial context, a client would be outraged if it cost $90 in legal fees to collect a $100 debt. There is a client very interested in controlling costs and a lawyer that must answer to the client. Sometimes, this does not seem to be true in preference litigation currently.

Creditors could certainly lower transaction costs by simply readily agreeing to send their preference money back. It is certain that some creditors fight preference actions longer than they should, because of perceived unfairness. It is also certain that many frivolous preference actions are filed.

This is a "volume" legal business, just like any collections practice. The preference collection lawyer has no real client to communicate with or collect information from. The current practice is to take the check ledger from the bankrupt debtor and send blanket demand letters to every creditor that received a check in the 90 days prior to bankruptcy. It has gotten to the point that many lawyers go straight to filing suit without even a demand letter. If you are already filing 50 identical lawsuits, it does not take much more effort to simply file 100. The costs of defense are so high that many creditors will simply pay blood money to get out. It is questionable, however, whether any of this is helping the pool of general unsecured creditors.

The Policy Problem

Anecdotal evidence suggests that little of this preference litigation is benefiting general unsecured creditors. Although preference litigation has become the norm in *every* bankruptcy, distributions to general unsecured creditors are still rare in *any* bankruptcy. It is not clear where all of the money is going. Certainly, much is lost in transaction costs and legal fees in collection of the preferences claims. This leads to the perception amongst creditors that preference litigation is just a cottage industry created by lawyers for lawyers.

Much of the proceeds go to other administrative costs of running the bankruptcy estate. These are again largely legal fees for the bankruptcy estate, the trustee and the general unsecured creditors' committee. Trade vendors and other creditors that extend new credit to the bankruptcy estate also have administrative expense priority. While an orderly bankruptcy process is an important policy objective, it is questionable whether general unsecured creditors who have already lost money should be paying the cost of this bankruptcy process by paying in even more money, especially if they do not benefit generally from the process they finance.

It has also become more common for courts to grant a "super priority" administrative claim to secured lenders in exchange for allowing the use of cash collateral. In other words, the debtor's bank normally has lent money to the debtor on a credit line and the bank has a security interest in all funds deposited in the debtor's bank accounts. When a debtor files a Chapter 11 bankruptcy, the objective is to reorganize and stay in business. However, the bank will freeze the debtor's bank accounts, making it impossible for the debtor to make payroll or pay trade vendors. This makes it impossible to stay in business. The debtor must offer the bank "adequate security" in exchange for the right to continue using these bank accounts. However, the debtor typically has no assets with any equity. The debtor's only unencumbered assets are its preference claims against its unsecured trade vendors that made the mistake of continuing to do business with them.

A common solution is to grant the bank a "super priority" administrative claim in exchange for allowing the use of cash collateral. This gives the bank first right to all proceeds of the preference actions. The bank is paid in full before any other administrative priority claims or general unsecured creditors get any proceeds from preference actions. It is ironic that a major purpose of the preference law was to protect "equality of distribution among creditors of the debtor."[168] Much case law concludes that unsecured creditors should repay preference payments received in the 90 days prior to a bankruptcy so that all general unsecured creditors are treated equally, when much of this money actually goes to secured creditors with super priority administrative claims. It is an important policy objective to allow businesses to reorganize in order to preserve jobs and maximize payments to creditors. However, it is questionable whether general unsecured creditors should be paying the cost of this, in order to make sure that secured creditors do not lose money in attempting a business reorganization.

It is also certain that the preference rule has not ended preferential payments, although it does make them more difficult. The 90-day rule for preferences is very arbitrary. A debtor can still prefer any creditor of their choosing. They just have to make sure that payment is made more than 90 days prior to the bankruptcy petition or more than a

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[168] *United Rentals, Inc. v. Angell*, 592 F.3d 525, 528 (4th Cir. N.C. 2010).

year[169] if the payment is made to an "insider."[170] It is unusual for insolvents to be this "organized," but there is also no question that this happens.

The "venue" rule is a particular problem in preference litigation. "Venue" concerns the city or state where any lawsuit must be filed. A bankruptcy generally must be filed in the district of the debtor's principal place of business or state of incorporation.[171] Any litigation related to that bankruptcy must then take place in that same court. This venue rule generally makes sense, but it creates fairness problems when the debtor has been doing business outside of their home state.

A real estate developer from Los Angeles, California, may build apartments buildings in Arlington, Virginia. If that California real estate developer files bankruptcy, many Virginia subcontractors and suppliers will lose money. When the bankruptcy estate begins preference litigation two years later, however, these same Virginia contractors will be forced to travel to California to defend preference claims. This runs afoul of the general venue rule that the plaintiff must travel to the defendant's place of residence to litigate or at least to the state where the contract was performed and the problem arose. It also dramatically increases the transaction costs to a preference defendant. A small Virginia-based carpentry contractor is not going to travel to California and hire a California lawyer to defend a $15,000 preference action, no matter how frivolous the preference claim. This defendant really has no choice but to pay blood money to be left alone.

Under the Bankruptcy Reform Act of 2005, a preference case under $10,000 must be filed where the preference defendant resides and not where the original bankruptcy petition was filed.[172] A corporate defendant resides in its state of incorporation or in the state containing its principal place of business.[173] This $10,000 limit does eliminate some of the unfairness in many small preference actions, but this limit should be increased or the venue rule changed for *all* preference actions.

There is no question that the preference litigation system still needs reform. On the other hand, the preference rule serves some important policy objectives. It is very difficult to say *how* this system should be reformed. The venue rule may be the most obvious. If a debtor decided to travel cross-country to do business, the bankruptcy estate should be forced to travel cross-country to pursue a preference claim. A bankruptcy court in Virginia could hear a preference claim just as well as a bankruptcy court in California. Much of the evidence and many of the witnesses will be there anyway. This is not such a fundamental portion of the bankruptcy that is cannot be separated to another court.

Under the Bankruptcy Reform Act of 2005, preferences must be at least $5,000.[174] If it is less, the case simply cannot be filed. This is a good start. It is still questionable whether many of these cases are truly benefiting general unsecured creditors and the unproductive transaction costs are high. Preference defendants will still face familiar problems with small cases above $5,000.

It may also be a good idea to adopt a higher limit *de minimis* rule. Defendants will not have to pay back a preference unless it is 30 percent more than what they would have received in a Chapter 7 liquidation. Maybe there should be a $10,000 or $20,000 minimum claim. In other words, bankruptcy estates can only go after big money or big discrepancies. Many preference defendants have already lost money by doing business with the debtor and did nothing wrong except allow the debtor to go too long without paying invoices. This would at least lower the overall transaction costs and lower the heat level—and it may not significantly lower the proceeds to the bankruptcy estate.

Finally, preference litigation should not benefit attorneys or even the bankruptcy administration system generally at the expense of general unsecured creditors. It would be nice to have some mechanism to ensure that preference litigation cannot be instituted unless the substantial majority of the recovery will actually be distributed to general unsecured creditors.

The Information Problem

In any legal case, the "burden of proof" can be important. If there are no documents and few witnesses, the judge may not be able to tell what happened. Whichever party had the burden of proof will lose. Normally the plaintiff

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[169] 11 U.S.C. §547(b)(4)(B).

[170] 11 U.S.C. §101(31).

[171] *See Collier on Bankruptcy* §4.01[2][D] (15th Edition Revised, Matthew Bender 2001).

[172] 28 U.S.C. §1409(b).

[173] A foreign corporation can be sued in any district court where the defendant has "minimum contacts."

[174] 11 U.S.C. §547(c)(9).

that filed the suit has the burden of proof. If the judge cannot tell what happened, the plaintiff will lose, because the plaintiff failed to meet its burden of proof.

The burden of proof in preference litigation is on the estate (trustee) on some issues and on the creditor-defendant on other issues. This is discussed below. The burden of proof is particularly important in preference litigation, because there is normally a shortage of documents, witnesses and other evidence.

In a bankruptcy, the debtor is normally going out of business. Even in reorganization, the employees and managers often change. Bankrupt debtors are normally poor record keepers to start with. This gets worse in the 90 days prior to bankruptcy. During the preference period, the debtor is normally losing employees and very busy trying to put out fires. This gets worse after bankruptcy is filed. Many records are lost and the rest are thrown into storage. The few remaining employees find new jobs and move on as fast as they can.

Preference actions are usually filed two years after the bankruptcy petition. To the extent the bankruptcy estate has the burden of proof and must produce information, they have a horrific problem of no witnesses and no documents.

In preference litigation, the estate (trustee) often operates entirely off of bank records and check registers. The debtor's bank will always be organized and can always produce bank statements showing what checks cleared the debtor's bank in the 90 days prior to bankruptcy. Debtors should compare this bank ledger with the debtor's accounts payable information and then file only meritorious cases that will benefit the general unsecured creditors. The more abusive preference lawyers will simply file suit against anyone who received a check during the preference period, sometimes referred to as "suing the checkbook." The better preference lawyers will not file suit unless the creditor was paid for invoices more than 60 days old.[175] It is rare for the estate (trustee) to do any further investigation on preference defenses. They normally do not have the records or witnesses to do so. In any event, they leave it up to the creditor-defendant lawyers to investigate the case.

To the extent that the creditor-defendant has the burden of proof, it will also have a problem collecting documents and other evidence. As discussed below, many preference defenses involve whether the creditor had mechanic's liens, payment bonds or trust funds. Most preference complaints are filed two years after the fact. Will the creditor be able to produce delivery tickets showing the delivery project? Will the creditor be able to identify the project owner or general contractor and determine whether they were holding funds on the bankrupt debtor? The creditor-defendant has an opportunity to have superior information, better documents and better witnesses than the estate (trustee) in a preference action. In order to preserve this advantage, however, the creditor must collect information at the time of the bankruptcy petition.

When a customer files bankruptcy, the creditor should promptly take note of checks received from that debtor in the 100 days prior to bankruptcy. (Remember, it is the date the check clears the debtor's bank that determines a preference payment.) Then, collect the invoices paid with those checks and determine the age of unpaid invoices. If they are all less than 60 days old, the creditor will probably not have a preference problem. These documents should be carefully placed in a credit management file, however, for easy reference two years later.

The creditor should now pretend that the payment was not received and determine whether there is an avenue to force payment. As discussed below, many of the defenses to preference actions involve mechanic's lien, payment bond, trust fund or other enforcement mechanisms. If the creditor could have enforced payment after bankruptcy, then the payment received may not be a preference. The creditor was not "preferred" by the payment. It is money the creditor would have received anyway through the mechanic's lien or bond process, even after the bankruptcy.

The creditor defendant that has good documents, good witnesses and other information about the transactions in preference litigation will have a tremendous advantage over the trustee who has only bank statements and invoices.

The Timing Problem

It will be difficult to collect information on lien and bond two years after the fact. Delivery tickets particularly will be much easier to collect 90 days after delivery rather than two years after delivery. Where was this construction project? Who was the owner? Who was the general contractor? Were they holding money or had your debtor been paid in full? Is there a payment bond on the project? As discussed below, these facts may be defenses to a preference action.

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[175] *See* subsection below, Defenses to a Preference Action.

Your own documents and witnesses will be much easier to find now rather than two years from now. Other witnesses who work for the owner or general contractor on the project will certainly be easier to find while the project is still ongoing. These witnesses will also have a much easier time getting documents to help you. In two years time, projects end, people change jobs, companies throw out documents and companies go out of business. It will take you less time now and you will have more success now. You can be pretty confident a preference claim will eventually be filed against your company, if it received large payments just before the bankruptcy. You might as well get ready now.

A claimant must normally enforce liens or bonds less than a year after supply of labor or materials. If you lose a preference case two years from now, it will certainly be too late to enforce your bond rights for the money you have to pay back. It may not help that you could have enforced your lien or bond rights back at the time the debtor paid you. It depends on whether the payment "depleted the estate."[176] You may actually need to file a mechanic's lien or bond claim now for money that you have been paid, in order to make sure you have security if you must repay a preference later. This makes more sense if you need to file a lien anyway on an uncollected receivable.

Consider requesting a bankruptcy court order shortening the time for the debtor to bring a preference action. It seems counter intuitive to force the debtor to sue you now, but it can solve a lot of problems. You can bring into the preference lawsuit the bonding company, the property owner and other players on the construction project, while you still have security and while they still have records or witnesses readily available. If you must repay the preference, the bonding company, general contractor or property owner may be liable to you.

As a practical matter, one of these players may be holding money on the debtor anyway. You can force the debtor to admit that the debtor would be paid less, if you did have to repay the preference. This will solve the triangulation problem for you.[177] More importantly, it removes the incentive for the debtor to litigate with you, because the debtor will not increase assets. The debtor will be motivated to settle or abandon the preference claim, particularly if they have hopes of reorganizing and continuing in business. It also helps that the business people for the debtor will still be involved in decision-making early in the bankruptcy, especially if these are the same people the creditor has dealt with. Two years after the bankruptcy filing, the debtor's business people have all found new jobs. Lawyers are now running the preference cases for the trustee and do not care about any business relationships. You will have a much harder time proving you would have had a lien two years earlier, and there is no chance to establish a lien now.

The Trustee's Burden of Proof

The estate (trustee) has the burden of proving that:

1. The creditor received property of the debtor within 90 days of the bankruptcy petition and while the debtor was insolvent
2. The preference enabled the creditor to receive more than it would have in a Chapter 7 liquidation
3. The payment was for or on account of an "antecedent debt."[178]

Once the trustee proves these three "above the line" issues, the burden is on the creditor to prove that a "below the line" defense exists.

The trustee will generally have an easier time with this "above the line" burden than the creditor-defendant will have with "below the line "defenses. It is normally easy to show that a payment or security interest was received within 90 days of the bankruptcy filing.[179] The trustee only needs the debtor's bank account statements to see what checks cleared in the 90 days prior to the bankruptcy petition.

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[176] *See* subsection below on Defenses to a Preference Action; sub-subsections, Contemporaneous Exchange for New Value and Triangulation.

[177] *See* subsection below on Defenses to a Preference Action; sub-subsections, Contemporaneous Exchange for New Value and Triangulation.

[178] According to 11 U.S.C. §547(b) the transfer must be:
(1) to or for the benefit of the creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made within 90 days before the date of filing the petition...; and
(5) that enables such creditor to receive more than such creditor would receive if
(A) the case were a case under Chapter 7 of this title;
(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

[179] 11 U.S.C. §547(f); *See Sandoz v. Fred Wilson Drilling Co*., 695 F.2d 833, 838 n.5 (5th Cir. 1983).

Normally, it is not difficult to prove that the payment was for an antecedent debt. This means only that the debtor owed the money before the payment was made. If, however, a creditor receives payment before supplying labor or materials, however, this cannot be a preference.[180]

In addition, *any* payment received by a creditor will normally be more than the creditor would have received as a general unsecured creditor in a Chapter 7 liquidation. If a debtor is in bankruptcy, liabilities typically exceed assets and the debtor has a negative net worth. In most Chapter 7 liquidations, secured creditors receive all proceeds and general unsecured creditors receive nothing. Accordingly, any payment received by an unsecured creditor during the preference period will normally be more than the theoretical Chapter 7 liquidation payout.

Bankruptcy trustees and the lawyers prosecuting preference actions normally have the frame of mind that they will have an easy time proving their case and the creditor-defendant has all of the problems. This is significant because of the problem with information, discussed above. It is not always accurate, however, and creditors have several opportunities to show that the trustee has not met its burden.

A creditor need not return a payment from the debtor if the creditor is no better off compared to other creditors of the bankruptcy estate than if the creditor waited for liquidation and distribution of the assets of the estate.[181] Unless the transfers by the debtor diminish the estate of the debtor, the creditor cannot be charged with a preference.[182]

Assumption of Contract

As discussed above,[183] the debtor can "assume" a contract with a creditor. Both sides are forced to continue performance of the contract, but the debtor must "cure all default." The pre-petition account receivable to this creditor must be paid in full before the contract is assumed. By the same token, if this creditor had received a payment during the preference period, it cannot be a preference. The creditor would have received the payment even in a Chapter 7 liquidation, if the contract was assumed.[184]

Similarly, if a general contractor files bankruptcy, it may wish to assume a profitable contract with a real estate owner. That prime contract probably states that the general contractor must pay for all labor and materials supplied to the project. If any of these subcontractors or suppliers receive payment shortly before the bankruptcy, these payments likewise cannot be preferences. The general contractor would have been required to make these same payments in a Chapter 7 liquidation, if the contract had been assumed. The debtor must cure *all* default before the contract is assumed. The court cannot rewrite the contract and then allow assumption. In other words, the debtor can choose which contracts it wishes to assume. However, if the debtor wishes to assume a contract, the debtor cannot choose which portions of the contract to assume. The assumption of a contract precludes a later attempt to recover payments made under that contract as a preference.[185] It is significant that the trustee has the burden of proof on this issue.

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[180] *In re Vanguard Airlines, Inc*., 295 B.R. 329, 335 (Bankr.W.D.Mo. 2003).

[181] *Smith v. Creative Financial Management, Inc.* (*In re Virginia-Carolina Financial Corp.*), 954 F.2d 193, 199 (4th Cir. 1992) (incorporating the rule from *Palmer Clay Prod. Co. v. Brown*, 297 U.S. 227, 229, 56 S. Ct. 450 (1936)).

[182] Unless the transfers by the debtor to the creditor are such that "the estate of the debtor is thereby diminished, the creditor cannot be charged with receiving a preference by transfer." *National Bank of Newport, NY v. National Herkimer County Bank of Little Falls*, 225 U.S. 178, 184, 32 S. Ct. 633, 635 (1912); *see also Continental & Commercial Trust & Sav. Bank v. Chicago Title & Trust Co.*, 229 U.S. 435, 33 S. Ct. 829 (1913). The Supreme Court has held that transfers amounting to preferences "contemplate the parting with the bankrupt's property for the benefit of the creditor and the consequent diminution of the bankrupt's estate." *Id.*, at 185, 32 S. Ct. at 635.

Payments are not preferential where "they do not deplete the debtor's estate or diminish the assets available for distribution among general creditors." *Small v. Williams*, 313 F.2d 39, 44 (4th Cir. 1963). The test of whether a preference has occurred is "not what the creditor receives but what the bankrupt's estate has lost…[because] it is the diminution of the bankrupt's estate, not the unequal payment to creditors, which is the evil sought to be remedied by the avoidance of a preference transfer." *Virginia Nat'l Bank v. Woodson*, 329 F.2d 836, 840 (4th Cir. 1964).

[183] *See* section above, Doing Business with the Debtor in Bankruptcy; subsection, Assumption or Rejection of Executory Contracts; *See Matter of Superior Toy & Mfg. Co., Inc.* 78 F.3d 1169 (7th Cir. 1996).

[184] *See In re LCO Enterprises*, 12 F.3d 938 (9th Cir. 1993); *Matter of Superior Toy & Mfg. Co., Inc.*, 78 F.3d 1169 (7th Cir. 1996).

[185] *See Kimmelman v. The Port Auth. of NY and N.J.* (*In re Kiwi Int'l Air Lines, Inc.*), 344 F.3d 311, 323 (3rd Cir. 2003) ["the trustee's preference actions against each of the defendants was precluded, as a matter of law, by the debtor's earlier assumption of its agreements with them..."]; *In re Superior Toy & Mfg. Co.*, 78 F.3d 1169, 1173-74 (7th Cir. 1996) ["An assumption order divests the trustee of subsequent claims to monies paid under the contract whether they were paid pre-petition or post-petition... Section 547 and [section] 365 are mutually exclusive avenues for a trustee"]; *Philip Servs. Corp. v. Luntz* (*In re Philip Servs. (Delaware), Inc.*), 284 B.R. 541, 553 (Bankr. D. Del. 2002) ["We conclude that once an executory contract is assumed, the trustee or debtor may not maintain a preference action to recover payments made pre-petition pursuant to that contract"], *aff'd* 303 B.R. 574 (D. Del. 2003).

Congress did not require that all defaults be cured prior to assumption with the intent of depriving the creditor of monies it received pre-petition. On the contrary, "Congress passed sec. 365 to insure that a contracting party is made whole before a court can force the party to continue performing with the bankrupt debtor. Permitting a preference suit after an assumption order would undermine that purpose."

Trust Fund Statutes and Agreements

Trust fund statutes and trust fund agreements are discussed in greater detail in other chapters of this book.[186] Such statutes or agreements dictate that when the owner of real estate pays a general contractor for labor and materials, the general contractor holds these funds "in trust" for the benefit of all subcontractors and suppliers that supplied the labor and materials. The general contractor may "hold" the money, but it does not "own" the money.[187] The subcontractors and suppliers are the real owners of the money. When the general contractor "pays" subcontractors and suppliers, they are only receiving their own money. It is not "property of the estate" of the general contractor. If the general contractor files bankruptcy, these payments cannot be preferences.[188]

A subcontractor or supplier can come to the same result in most states with the use of a trust fund agreement in their contract to supply labor or materials, whether or not that state has a trust fund statute.[189] It is possible that the creation of a trust fund agreement during the preference period is not an avoidable preference.[190] Please review other chapters of this book for further information.[191] However, state (not federal) property law creates and defines the

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Whether the trustee can show that the payments enabled a creditor to receive more than such creditor would have received in a hypothetical Chapter 7 depends on "whether the debtor elects to assume the contract pursuant to sec. 365. If the contract is not assumed, the contracting party is subject to sec. 547(b). If the contract is assumed, the contracting party is entitled to receive all amounts in arrears in exchange for forced performance." *In re Superior Toy & Mfg. Co.*, 78 F.3d at 1172. Therefore, "Section 547 and sec. 365 are mutually exclusive avenues for a trustee. A trustee may not prevail under both." *Id.* at 1174. "The Trustee cannot use §547(b) to circumvent the requirement of §365(b)." *In re LCO Enterprises*, 12 F.3d at 943.

"Because assumption acts as a renewed acceptance of the terms of the executory bargain, the Bankruptcy Code provides that the cost of performing the debtor's obligations is an administrative expense of the estate, which will be paid first out of the assets of the estate." *In re Columbia Gas System, Inc.*, 50 F.3d 233, 238-39 (3rd Cir. 1995). "By contrast, general unsecured creditors are entitled to receive only a *pro rata* distribution of the debtor's unencumbered assets that remain after such priority claims and others are paid. For this reason, a creditor whose contract is assumed under §365 is not similarly situated to general unsecured creditors." *In re Kiwi Int'l Air Lines, Inc.*, 344 F.3d at 318 [Citations omitted].

[186] *See* chapter, Trust Fund Laws and Agreements.

[187] The United States Supreme Court has stated "[t]hat Congress plainly excluded property of others held by the Debtor in trust at the time of the filing of the petition." *See* §541(b); H.R.Rep. No. 95-595, p. 368 (1977); S.Rep. No. 95-989, p. 82 (1978). *United States v. Whiting Pools*, 462 U.S. 198, 205 n10, 103 S.Ct. 2309, 2314 (1983). The United States Supreme Court also held that the Bankruptcy Trustee has no real interest in funds held in trust for the benefit of another. *Begier v. I.R.S.*, 496 U.S. 53, 59 (1990). The Trustee holds only bare legal, and not equitable, title. The Debtor's legal interest is only the right to receive the funds, hold the funds in trust and pay the funds to the trust beneficiary. *Id.*

According to the United States Supreme Court, a "[p]roperty interest in a fund not owned by a bankrupt at the time of adjudication, whether complete or partial, legal or equitable, mortgage or liens, or simple priority of rights, are of course not a part of the bankrupt's property and do not vest in the trustee. The Bankruptcy Act simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors." *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 135-36, 83 S. Ct. 232, 234 (1962).

See Universal Bonding Insur. Co. v. Gittens and Sprinkle Enter., Inc., 960 F.2d 366 (3d Cir. 1992); *Huizinga v. U. S.*, 68 F.3d 129 (6th Cir. 1995); *In re Marrs-Winn Co. Inc.*, 103 F.3d 584 (7th Cir. 1996) ["It is a well-settled principle that debtors do not own an equitable interest in property that they hold in trust for another, and thus, those trust funds are not 'property of the estate'"], *citing City of Farrell v. Sharon Steel Corp.*, 41 F.3d 92, 95 (3d Cir. 1994)); *In re Omegas Group, Inc.*, 16 F.3d 1443, 1449 (6th Cir. 1994) ["A debtor that served prior to the bankruptcy as trustee of an express trust generally has no right to assets kept in trust..."]; *see also T&B Scottdale Contractors Inc. v. U. S.*, 866 F.2d 1372, 1376 (11th Cir. 1989) [where the parties have agreed that the funds were meant solely for materialmen, the property is not part of the bankruptcy estate].

The debtor has a property right in such funds only to the extent that there is a balance remaining after all the trust beneficiaries have been paid. *Selby v. Ford Motor Co.*, 590 F.2d 642, 646 (6th Cir. 1979), *citing Aquilino v. U.S.*, 10 N.Y.2d 271, 279 (1961) (decision on remand from Supreme Court of the United States). In other words, a contractor receiving payment must pay the supplier on the project first, before taking his profit. The Bankruptcy Trustee "has no right to appropriate for the benefit of general creditors funds transferred to subcontractors by the contractor or owner." *Id.* 644.

Funds paid to the debtor-contractor under the New Jersey Trust Fund Statute did not become part of the bankrupt estate and could not be used in the debtor's reorganization. *Universal Bonding Insur. Co. v. Gittens and Sprinkle Enter., Inc.*, 960 F.2d 366, 371 (3d Cir. 1992). The debtor had not "*ever* possessed the right to use the contract balances at issue here for its own benefit." [Emphasis added.] Once the funds were in fact paid to the debtor, the debtor must hold those funds for the benefit of the beneficiaries only. *Id.* at 373. As the estate of the debtor can take no more than the debtor, the estate would not be permitted to use funds held in trust to satisfy its general creditors. *Id.* at 372.

[188] *Wolff v. United States, IRS (In re FirstPay, Inc.)*, 773 F.3d 583 (4th Cir. Md. 2014); *Mandross v. Peoples Banking Co. (In re Hartley)*, 825 F.2d 1067, 1070 (6th Cir. 1987) *citing Grubb v. General Contract Purchase Corp*., 94 F.2d 70, 72 (2nd Cir. 1938) [The transferred funds "w[ere] not preferential because the funds did not belong to the debtor: the debtor never controlled the money, and the money never became a part of the debtor's assets].

[189] *Wolff v. United States, IRS (In re FirstPay, Inc.)*, 773 F.3d 583 (4th Cir. Md. 2014); *Holmes Envtl. v. Suntrust Banks (In re Holmes Envtl., Inc.)*, 287 B.R. 363, 382 (Bankr. E.D. Va. 2002) [Having concluded that an express trust was created at the execution of the Subcontract and the Escrow Agreement, and the monies paid into escrow are therefore not estate property, it logically follows that no preferential transfer occurred here...Here the funds in the escrow account representing the monies earned by the performance of the Contract are not estate property; therefore, no preference can occur].

[190] *Holmes Envtl. v. Suntrust Banks (In re Holmes Envtl., Inc.)*, 287 B.R. 363, 382, fn. 22 (Bankr. E.D. Va. 2002).

[191] *See* chapter, Trust Fund Laws and Agreements.

scope of a trust for purposes of the Bankruptcy Code.[192] Federal bankruptcy law recognizes and enforces the property rights created by state law.[193]

A long document with various provisions is unnecessary. If it is clear that the creator of the trust (settlor) intended to create a trust and did not intend the trustee to take ownership of the property, then a trust exists. The language can be quite short as long as the intent is clear.[194] On the other hand, it is apparent that voluntary trust fund agreements will have more difficulty in a bankruptcy court than will trust fund statutes. Bankruptcy courts have stated that they are "not inclined to allow creditors to utilize a trust theory as a means of obtaining preferential treatment in a bankruptcy," since "equality of distribution among creditors is a central policy of the Bankruptcy Code.[195] The mere use of the word "trust" may not succeed in providing preferential treatment.[196] The issues of tracing, commingling and an identifiable trust fund, discussed above, can still be a problem.[197]

In any event, this has great potential as a preference defense, especially in states with trust fund statutes. The trustee has the burden of proof on this "above the line" element of a preference claim. The trustee must prove that these payments enabled the creditor to receive more than the creditor would have received in a liquidation case under Chapter 7. This may include the burden of showing that the funds were not subject to the trust fund statute.[198] This is difficult to do when the trustee has only a check register.[199]

A payment by a trustee to a trust beneficiary cannot diminish the trustee's estate, since the funds were never part of the estate. Unless the transfers by the debtor diminish the estate of the debtor, the creditor cannot be charged with a preference.[200]

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[192] State law trusts may be "imposed against specific assets [of the debtor] and those assets do not become part of the bankrupt's estate." *Mid-Atlantic Supply, Inc. v. Three Rivers Aluminum Co*. (*In re Mid-Atlantic Supply Co*.), 790 F.2d 1121, 1125 (4th Cir. Va. 1986) [a joint check agreement case], *quoting In re Kennedy & Cohen, Inc.,* 612 F.2d 963, 966 (5th Cir. 1980). Legal title alone is "of no value to the estate and the debtor will be required to reconvey the property or its substitute to the beneficial owner." *Id.* Accordingly, "if a trust, whether express, statutory or constructive, is established over property in the possession of the trustee or debtor in possession, the sole permissible administrative act of the trustee or debtor in possession is to pay over or endorse over the property to the beneficiary or beneficiaries of the trust." *Id.* at 1126.

[193] *Selby v. Ford Motor Co.*, 590 F.2d 642, 647 (6th Cir. 1979).

[194] *M&T Elec. Contrs., Inc. v. Capital Lighting & Supply, Inc. (In re M&T Elec. Contrs., Inc.),* 267 B.R. 434, 479-480 (Bankr. D.D.C. 2001), *citing Old Republic Nat'l Title Ins. Co. v. Tyler (In re Dameron)*, 155 F.3d 718 (4th Cir. Va. 1998) [An express trust is created when the parties affirmatively manifest an intention that certain property be held in trust for the benefit of a third party. *See Peal v. Luther*, 97 S.E.2d 668, 699 (Va. 1957)]; *Holmes Envtl. v. Suntrust Banks (In re Holmes Envtl., Inc.),* 287 B.R. 363, 375 (Bankr. E.D. Va. 2002) [An express trust may be created "without the use of technical words." All that is necessary are words, or circumstances "which unequivocally show an intention that the legal estate was vested in one person, to be held in some manner or for some purpose on behalf of another…" *Broaddus v. Gresham*, 26 S.E.2d 33, 35 (Va. 1943)]*; see also Woods v. Stull*, 30 S.E.2d 675, 682 (Va. 1944); *Schloss v. Powell*, 93 F.2d 518, 519 (4th Cir. Va. 1938); *May v. Michael*, 18 Md. 227 (1862); *Sieling v. Sieling*, 151 Md. 536 (1926).

[195] *In re Kulzer Roofing, Inc*., 139 B.R. 132, 138 (Bankr. E.D. Pa. 1992); *See also In re Morales Travel Agency*, 667 F.2d 1069, 1071 (1st Cir. P.R. 1981) [If a ritualistic incantation of trust language were deemed conclusive, it would be a simple matter for one creditor, at the expense of others, to circumvent the rules pertaining to the creation of bona fide security interests].

[196] *In re Kulzer Roofing, Inc*., 139 B.R. 132, 142 (Bankr. E.D. Pa. 1992); *In re Morales Travel Agency*, 667 F.2d 1069, 1072 (1st Cir. P.R. 1981).

[197] *See* chapter, Trust Fund Laws and Agreements.

[198] *Wolff v. United States, IRS (In re FirstPay, Inc.)*, 773 F.3d 583, 595 (4th Cir. Md. 2014) [in the absence of contrary proof, the law will presume that any funds received, held, and ultimately transferred by a trustee in accordance with the trust purpose are indeed trust funds. The burden rests with the trustee to rebut that presumption and establish that the funds so held and transferred, or any portion thereof, were not subject to a trust but were the trustee's own property prior to transfer]; *Casco Electric Corp. v. Wesco Corp.*, 28 B.R. 191 (Bankr. E.D.N.Y. 1983); *Bethlehem Steel Corp v. Tidwell*, 66 B.R. 932 (M.D.Ga. 1986); *IT Group v. Jointa Galusha, LLC and Waste Recovery*, 326 B.R. 270 (Del. 2005), *citing Cooper v. Grisofe Electric Corporation (In re Building Dynamics, Inc.)*, 134 B.R. 715, 717 (Bkrtcy.W.D.N.Y. 1992).

[199] "Because of the way in which Casco maintained its records and paid its creditors, it cannot now be determined what money from those projects Casco had on hand when it paid Wesco. But, as Wesco points out, the burden lies on the trustee to establish every element of a preference, including the fact that the money given it constituted property of the debtor. If the money represented assets of the statutory trust created by New York's Lien Law in Wesco's favor, its receipt by Wesco was not a preference. Since it is undeniable that Casco received monies constituting trust assets, the burden lay on the trustee to prove that the money paid Wesco was not part of such trust assets. Indeed, it is arguable that by the very act of payment, Casco identified the funds as trust assets." *Casco Electric Corp. v. Wesco Corp*, 28 B.R. 191 (Bankr. E.D.N.Y. 1983).

[200] The harm to creditors is minimal as the funds were "never part of the bankruptcy estate, so creditors never had a claim to them." *See City of Springfield, MA v. Ostrander* (*In re Lan Tamers, Inc*.), 329 F.3d 204, 215 (1st Cir. 2003). "Unsecured creditors should not be permitted to share in monies…which [the debtor] would not be permitted to retain for its own use." *In re United Milk Prods. Co.*, 261 F. Supp. 766, 768 (N.D. Ill. 1966).

A creditor may not even be aware that trust fund protection exists while they are doing business. Trust provisions in contracts create a trust without any "perfection" by the creditor.[201] Once the credit agreement or other contract is signed, the trust mechanism is passive and does not require further action from the creditor. Investigation after a preference complaint, however, can reveal a complete defense to the preference action.

Equitable Liens

Other chapters of this book explain the operation of trust fund statutes, trust fund agreement and equitable liens. These theories can be used to both collect money and to defend preference actions.[202] Trust fund theories are "above the line" arguments, discussed above, on which the trustee has the burden of proof.

Equitable lien theories are less tested and more uncertain than trust fund theories but have many similarities. When a contractor supplies labor or materials to a customer and that customer later receives payment for those labor and materials, those funds are impressed with an "equitable lien" in favor of the creditor. The debtor would not have those funds, unless the creditor had supplied the labor and materials. This theory has had some success for the purpose of collecting funds held by an owner in construction contracting cases.[203] There is no known bankruptcy court case using this theory as a preference defense, but it is a viable theory.[204]

It is not entirely clear whether this would be an above the line argument or a defense, but it should be above the line either because the preference defendant is a secured creditor or because the preference payment was not property of the estate. When a debtor contractor breaches its contract, the debtor is not entitled to retained funds. These funds are not property of the estate.[205]

Earmarking

Earmarking of payments for the benefit of a creditor is another possible above the line defense to a preference claim. If a third party pays a creditor directly, the transfer is not "property of the debtor."[206] For example, if a real estate owner pays a material supplier directly, the transfer is not "property of the general contractor." The payment is "earmarked" for distribution to the creditor and no preference occurs. It is often relevant whether the payer had an independent obligation to the creditor through mechanic's lien or payment bond rights.[207] Earmarking is an amorphous concept that receives various names and treatments by courts.[208]

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[201] It matters not whether the creditors' claim is perfected as the monies were held in trust for the creditor and never became a part of the debtor's estate. *Cutler-Hammer, Inc. v. Wayne*, 101 F.2d 823, 825 (5th Cir. 1939), cert. denied, 307 U.S. 635, 59 S. Ct. 1031 (1939). "[I]t therefore matters not whether a creditor of the estate is secured or unsecured as neither will have a claim to that which never enters the estate." *Id.*

[202] *See* chapter, Trust Fund Laws and Agreements; *see also* chapter, Equitable Remedies; section, Equitable Liens.

[203] *In re RAH Development Corp. Inc.*, 184 B.R. 525 (W.D. Mich. 1995); *Framingham Tr. Co. v. Gould-National Batteries*, 427 F.2d 856 (1st Cir. 1970); *In re Underground Storage Tank Service, Inc.*, 12 B.R. 564 (E.D. Mich. 1997); *Tradesman International v. Lockheed Martin Corporation*, 241 F.Supp.2d 1337 (Kan. 2003). *See also* chapter, Equitable Remedies; subsection, Equitable Liens.

[204] For example, the equitable lien granted a surety entitles it to precedence over the trustee in bankruptcy of the debtor-contractor. *In re E.R. Fegert, Inc.*, 88 B.R. 258 (9th Cir. 1988) (*aff'd, In re E.R. Fegert, Inc. II*, 887 F.2d 955, 9th Cir. 1989).

[205] *In re Jones Constr. & Renovation, Inc.*, 337 B.R. 579, 585 (Bankr. E.D. Va. 2006), *citing First Indem. of Am. Ins. Co. v. Modular Structures* (*In re Modular Structures*), 27 F.3d 72 (3d Cir. N.J. 1994) and *Tri-City Serv. Dist. v. Pacific Marine Dredging and Constr.* (*In re Pacific Marine Dredging and Constr.*), 79 B.R. 924, 929 (Bankr. D. Ore. 1987).

[206] *See In re Superior Stamp & Coin, Co.,* 223 F.3d 1004 (9th Cir. 2000).

[207] Payments made by a debtor of a bankrupt to a creditor of the bankrupt pursuant to a direct legal obligation are not avoidable as preferences, because the payments do not constitute property of the estate. *M&T Elec. Contrs., Inc. v. Capital Lighting & Supply, Inc. (In re M&T Elec. Contrs., Inc.)*, 267 B.R. 434, 483 (Bankr. D.D.C. 2001; *see also Tri-Co. v. Star Bldg. Sys. (In re Tri-Co.),* 221 B.R. 606, 609 (Bankr. D. Mass. 1998).

[208] In *Keenan Pipe & Supply Co. v. Shields*, 241 F.2d 486 (9th Cir. 1956), a bankruptcy trustee unsuccessfully argued that the supplier receiving payment directly from the general contractor was effectively collecting on the debtor's account receivable, diminishing the value of the estate. *Id*. at 490. The court dismissed that argument as "erroneous ... as the check never entered the estate of [the debtor]" "[I]f the prime contractor or the subcontractor dedicates a specified sum to pay the laborer or materialman to discharge the obligation place upon the contractor ... no one else can assert any claim to money so paid." *Id*. at 489. The pool of funds from which unsecured creditors may recover was not diminished. If it was the obligation of the general contractor to see that the material bills were paid, and he paid them directly, "that is no concern of the Trustee. By no devise can it be conceived that these moneys entered the estate of [the debtor]." *Id at 490.*

See Texas American Bancshares, Inc. v. Clarke, 954 F.2d 329 (5th Cir. 1992) ["payment to a creditor of an insolvent estate by a source other than the estate does not create a preference, and any equal treatment required is based upon the creditor's share of the estate, not on benefits received from the collateral source"]; *see Brown v. First Nat'l Bank of Little Rock, Ark.*, 748 F.2d 490 (8th Cir. 1984) ["payments made to a debtor's creditors by an endorser, surety, guarantor, or payor in a business relationship with the debtor are not preferences because there is no transfer and resulting diminution of the debtor's estate"]; *see also DeAngio v. DeAngio*, 554 F.2d 863 (8th Cir. 1977); *Downriver Comm. Fed. Credit Union v. Penn. Square Bank*, 879 F.2d 754 (10th Cir. 1989), *cert. denied,* 493 U.S. 1070, 110 S. Ct. 1112 (1990).

Earmarking is more complicated where the debtor receives funds with specific instructions to use the funds to pay a specified creditor.[209] The debtor and new creditor have an agreement that the funds are to pay an old creditor.[210]

There must be an express agreement for the use of the funds.[211] Courts are in agreement that there are three parties in every earmarking. There is the "old creditor" (the pre-existing creditor who is paid off within the 90-day period prior to bankruptcy), the "new creditor" or "new lender" who supplies the funds to pay off the old creditor, and the debtor. When new funds are provided by the new creditor to the debtor for the purpose of paying the obligation owed to the old creditor, the funds are said to be "earmarked" and the payment is not a voidable preference.

Secured Creditors

If a *secured* creditor received a payment during the preference period, this may not have been a preference. *If* there were sufficient equity in the security property, the secured creditor would have been paid in full in a Chapter 7 liquidation. The trustee will fail to meet the burden of proving this element of a preference. [212]

A pre-petition payment to a fully secured creditor of the debtor is not preferential. If the creditor was not paid by the debtor's pre-petition transfer, then the creditor would be paid out of its collateral. A pre-petition transfer on a secured debt eliminates one debtor asset (transferred payment), but simultaneously augments another (by increasing debtor's equity in the collateral). Since no net depletion of assets occurs, other creditors are not harmed, and the transfers are not avoidable. [213]

Mechanic's Liens in Debtor Real Estate

Mechanic's lien claimants may be in this posture.[214] If the owner of the real estate is the bankrupt debtor, then a contractor supplying labor and materials has a mechanic's lien in the debtor's real estate. If the contractor received payment during the preference period *while the contractor is still within time to perfect the mechanic's lien*, then it is not a preference. The contractor could have enforced its mechanic's lien and would have received the same payment in a Chapter 7 liquidation.

It is important to note that the contractor must still be within time to perfect the mechanic's lien when the check cleared the bank. If the contractor allowed the mechanic's lien to expire by the time the check cleared the bank, then the payment has again become a preference.[215] This again proves that contractors should never let mechanic's liens expire.

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[209] *The St. Joe Company v. Norfolk Redevelopment and Housing Authority*, 283 Va. 403,407-08, 722 S.E.2d 622,625 (2012); *Patterson v. America's Voice, Inc. (In re America's Voice, Inc.)*, 2000 U.S. Dist. LEXIS 14761 (D.D.C. Oct. 4, 2000) [Neither case a bankruptcy preference].

[210] Regardless of whether the payment is transferred directly to the creditor or is paid with the understanding that the funds be used pay a creditor, the result is the same and no preference occurred. *See In re Superior Stamp & Coin, Co.,* 223 F.3d 1004 (9th Cir. 2000); The debtor holds the funds "in trust," never "controlled" the funds and the payment does not diminish the debtor's estate. *See In re Bohlen Enter., Inc.,* 859 F.2d 561 (8th Cir. 1988).

When a third person loans money to a debtor specifically to enable him to satisfy the claim of a designated creditor, the general rule is that the proceeds are not the property of the debtor; therefore, the transfer of the proceeds to the creditor is not preferential. *In re Hartley*, 825 F.2d 1067 (6th Cir. 1987).

A transfer is a preference only if the property transferred belongs to the debtor; if the transfer is made from money of third person to creditor of debtor, or to debtor with instructions to pay off another creditor, that is not avoidable preference. *In re Van Huffel Tube Corp*. 74 BR 579 (BC ND Ohio 1987).

[211] The transaction should meet the following requirements to qualify for the earmarking doctrine:

(1) the existence of an agreement between the new lender and the debtor that the new funds will be used to pay a specified antecedent debt,

(2) performance of that agreement according to its terms, and

(3) the transaction viewed as a whole (including the transfer in of the new funds and the transfer out to the old creditor) does not result in any diminution of the estate.

See In re Bohlen Enter., Inc., 859 F.2d 561 (8th Cir. 1988).

[212] *Smith v. Creative Fin. Mgmt., Inc.* (*In re Virginia-Carolina Fin. Corp.*), 954 F.2d 193, 199 (4th Cir. 1992).

[213] *Smith v. Creative Fin. Mgmt., Inc.* (*In re Virginia-Carolina Fin. Corp.*), 954 F.2d 193, 199 (4th Cir. 1992).

[214] *See In re Johnson*, 25 B.R. 889 (E.D. Tenn. 1982); *Ricotta v. Burns*, 264 F.2d 749 (2nd Cir. 1959); *In re Cimmaron Oil*, 71 B.R. 1005 (ND Tex. 1987); *See also* cases concerning other statutory liens including *In re Tower Air*, 319 B.R. 88 (DE 2004); *Lease A-Fleet v. Wolk*, 151 B.R. 341 (E.D. PA 1993).

[215] *In re White*, *64 B.R. 843* (E.D. Tenn. 1986); *In re JA Jones*, 361 B.R. 94 (Bankr. W.D. NC 2007); *In re Joseph M. Eaton Bldrs, Inc.,* 84 B.R. 56 (W.D. Pa. 1988).

Lien on Funds Statute

Some states have a "Lien on Funds Statute."[216] Under a Lien on Funds Statute, funds owed to a debtor are impressed with a lien for the benefit of a labor or material supplier. This would be a lien on property of the estate.

If the Lien on Funds were a security interest in property of the debtor at the time of the transfers, then the transfer payment would not be a preference.

This Lien on Funds may exist from the date the project started or the first furnishing of labor or material. Depending on the wording of the statute, the lien may not exist until the claimant takes an affirmative step such as sending a notice.[217] This difference in timing could determine whether the transfer payment would be a preference.

Burden of Proof: More than Chapter 7 Distribution and Diminution of the Estate

In order to establish an avoidable preference, the trustee has the burden to prove that a transfer payment made in the 90-day preference period is an interest of the debtor in property and was made:

> (1) to or for the benefit of a creditor; (2) for an account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made on or within 90 days before the date of the filing of the petition; (5) *that enables such creditor to receive more than such creditor would receive if*: (A) *the case were a case under Chapter 7 of this title;* (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title.[218]

What if the creditor could have received the same payment in Chapter 7 liquidation, because of the creditor's lien on funds, payment bond or mechanic's lien on real property? This Bankruptcy Code section seems to say that the trustee has the burden and would have to prove that the lien or bond creditor would not have been paid in Chapter 7 liquidation. If the creditor could successfully obtain payment after a bankruptcy petition, then receipt of the same payment pre-petition cannot be an avoidable preference, as long as the bankruptcy estate was not diminished. The trustee would have the burden to prove that this same creditor would not have received this same payment in a Chapter 7 and prove that the bankruptcy estate was diminished.

However, this is not how courts seem to interpret the trustee's burden. Lien or bond creditors are often compared to general unsecured creditors. Courts often limit their analysis to what the creditor would have been paid *directly from the estate* as a general unsecured creditor in the hypothetical Chapter 7 distribution.[219] In considering what the creditor would have received in the hypothetical Chapter 7 distribution, there is no consideration of liens or bonds. It is interesting and important to note that the Bankruptcy Code section above does not say and no known court has ever directly stated that all creditors, including lien and bond creditors, should be compared only to general unsecured creditors for this hypothetical Chapter 7 distribution test. [220]

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[216] For example, NC Gen. Stat. §44A-18 (2009).

[217] *See e.g., In re Shearin Family Investments, LLC*, Case No. 08-07082-8-JRL (Bankr. E.D.N.C., April 17, 2009).

[218] 11 U.S.C. §547(b) (2009) [Emphasis added].

[219] The bankruptcy court had ruled in *United Rentals, Inc. v. Angell*, 592 F.3d 525, 529-30 (4th Cir. N.C. 2010) that the trustee had met the burden of 11 U.S.C. §547(b), by showing just that a general unsecured creditor would not have received full payment directly from the Chapter 7 bankruptcy estate. The existence of mechanic's lien or bond rights played no role in this analysis, nor the ability to enforce those rights in a Chapter 7 bankruptcy, nor whether the estate was diminished.

[220] It is possible that the words "to the extent provided by the provisions of this title" at the end of 11 U.S.C. §547(b) (2009) mean that the preference payment should be compared with a distribution directly from the estate as a general unsecured creditor in the hypothetical Chapter 7 distribution. Again, however, there is no known court case stating this directly.

This analysis is consistent with the Ninth Circuit's decision in *Committee of Creditors Holding Unsecured Claims v. Koch Oil Company (In re Powerine Oil Company),* 59 F.3d 969, 971- 73 (9th Cir. 1995), where the court determined that such a limited analysis was appropriate despite the illogical outcome. ["Can an unsecured creditor be better off when the debtor defaults rather than paying off the debt? Yes: Law can be stranger than fiction in the Preference Zone"].

The panel in *Powerine* could not reach a consensus on this very issue. The dissent stated that "[t]he plain language of the statute does not limit consideration to funds from the [debtor's] estate." *In re Powerine Oil Company*, 59 F.3d at 974.

Both the Fourth Circuit in *United Rentals, Inc. v. Angell*, 592 F.3d 525, 528 (4th Cir. N.C. 2010) and the Ninth Circuit in *Powerine* turn to a Fourth Circuit decision that does not seem to support their conclusions. In *Smith v. Creative Financial Mgmt, Inc.* (*In re Virginia-Carolina Fin. Corp.*), 954 F.2d 193 (4th Cir. 1992), the creditor could have made a claim against a third party for payment of its debt had it not received payment from the debtor. However, that third party would not have had anything more than an unsecured claim against the debtor's estate or estate assets. This means that the estate was diminished and the *Virginia-Carolina Financial Corporation* court determined that the bankruptcy trustee had met its burden of proof under §547(b)(5).

Conventional secured creditors, such as mortgage lenders, are not compared to general unsecured creditors for this test. In the case of conventional secured creditors, courts say only that if the creditor were not paid by the debtor's pre-petition transfer, then the creditor would be paid out of its collateral. Since no net depletion of assets occurs, other creditors are not harmed, and the transfers are not avoidable.[221] It is not clear why this same analysis does not apply to lien and bond creditors.

Courts have consistently said that payments which have the effect of releasing assets of comparable value to the claims of general creditors are not preferential.[222] They are not preferential because "they do not deplete the debtor's estate or diminish the assets available for distribution among general creditors." The test of whether a preference has occurred is "not what the creditor receives but what the bankrupt's estate has lost…[because] it is the diminution of the bankruptcy's estate, not the unequal payment to creditors, which is the evil sought to be remedied by the avoidance of a preference transfer."[223]

The United States Supreme Court has held that unless the transfers by the debtor to the creditor are such that "the estate of the debtor is thereby diminished, the creditor cannot be charged with receiving a preference by transfer."[224] The Supreme Court has also stated that transfers amounting to preferences "contemplate the parting with the bankrupt's property for the benefit of the creditor and the consequent diminution of the bankrupt's estate."[225] These statements would again indicate that the trustee has the burden to prove that the transfers placed the creditor in a better position than it would have been in a hypothetical Chapter 7 and that the estate was diminished.[226]

In support of this holding, the *Virginia-Carolina Financial Corporation* court wrote, "[t]he court must focus, not on whether a creditor may have recovered all of the monies owed by the debtor from any source whatsoever, but instead upon whether the creditor would have received less than a 100% payout in [a] Chapter 7 liquidation." Both the Fourth and Ninth Circuits have used this language as a basis to require comparison of the transfer to a distribution as a general unsecured creditor directly from the bankruptcy estate.

However, to say that the court must not focus on whether a creditor may have recovered all of the monies "from any source whatsoever," however, does not mean that there is only *one* source of funds shielded from preference attack, a distribution to general unsecured creditors directly from the bankruptcy estate. The critical question instead should be whether this particular creditor could have received the same payment in a Chapter 7 liquidation and whether the estate was diminished by the pre-petition transfer.

The Ninth Circuit in *In re Powerine Oil Company* relies on a pre-Bankruptcy Code decision stating that "the key factor in determining whether a payment is a preference is the 'percentage ... [creditors'] claims are entitled to draw out of the estate of the bankrupt.'" The 1902 decision cited, *Swarts v. Fourth National Bank*, 117 F. 1 (8th Cir. 1902), does not answer the question whether a payment that eliminates the secured claim of a third party is a preference. In fact, there the Eighth Circuit extensively analyzed the diminishing effect the preferential transfer had on the debtor's estate, noting that the third party would have an unsecured claim against the bankruptcy estate if called upon to pay the creditor. The statements relied on by the Ninth Circuit are merely an acknowledgment that the transfers were preferential because they would diminish the estate.

In re Virginia-Carolina Fin. Corp., 954 F.2d at 199, the Fourth Circuit cites the late Professor Countryman for the premise that "the court must focus, not on whether a creditor may have recovered all of the monies owed by the debtor *from any source whatsoever*, but instead upon whether the creditor would have received less than a 100% payout in a Chapter 7 liquidation." In turn, Professor Countryman looked to *Palmer Clay Products Co. v. Brown*, 297 U.S. 227, 80 L. Ed. 655, 56 S. Ct. 450 (1936) for his analysis. *See* Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 Vand. L. Rev. 713, 735-37 (1985) ["most courts have had no difficulty in reading Section 547(b)(5) as incorporating the rule of Palmer Clay Products: a preferential effect exists if the trustee can establish that a defendant unsecured, nonpriority creditor, without the allegedly preferential payment or lien, would have received less than a 100% payout in Chapter 7 liquidation"].

Palmer Clay Products Co. v. Brown, 297 U.S. 227, 80 L. Ed. 655, 56 S. Ct. 450 (1936), much like *Virginia-Carolina Financial Corporation* and *Swarts*, did not present a conflict between diminishment of the estate and the source of payment. *Palmer Clay Products* involved a bilateral transaction where the source of the transfers was never a concern. The primary issue in *Palmer Clay Products* was whether the analysis of preferential effect was to be made based upon the transfer date or the petition date. The source of the alleged preferential payments was not an issue. *Neuger v. United States* (*In re Tenna Corporation*), 801 F.2d 819, 822 (6th Cir. 1986).

The question remains whether the transfer must be compared only to payment as a general unsecured creditor in a direct distribution from the bankruptcy estate. It is respectfully submitted that there is no authority for this.

[221] *Smith v. Creative Fin. Mgmt., Inc.* (*In re Virginia-Carolina Fin. Corp.*), 954 F.2d 193, 199 (4th Cir. 1992).

[222] *Small v. Williams*, 313 F.2d 39, 44 (4th Cir. 1963).

[223] *Virginia Nat'l Bank v. Woodson*, 329 F.2d 836, 840 (4th Cir. 1964).

[224] *National Bank of Newport, NY v. National Herkimer County Bank of Little Falls*, 225 U.S. 178, 184, 32 S. Ct. 633, 635 (1912); *see also Continental & Commercial Trust & Sav. Bank v. Chicago Title & Trust Co.*, 229 U.S. 435, 33 S. Ct. 829 (1913).

[225] *National Bank of Newport,* 225 U.S. at 185, 32 S. Ct. at 635.

[226] *Hall v. Chrysler Credit Corp. (In re JKJ Chevrolet)* 412 F.3d 545, 551 (4th Cir. 2005) [requiring that the trustee establish that the creditor "received more from pre-petition payments than it would have received in a Chapter 7 proceeding"]; *Batlan v. Transamerica Commercial Fin. Corp.* (*In re Smith's Home Furnishings, Inc.*), 265 F.3d 959 (9th Cir. 2001); *Kimmelman v. Port Authority* (*In re Kiwi Int'l Air Lines*) 344 F.3d 311, 317 (3rd Cir. 2003) ["the trustee must establish that the transfer yielded the creditor a greater return on its debt than it would have received if the transfer had not taken place and it had received a distribution under a Chapter 7 liquidation"]; *Krafsur v. Scurlock Permian Corp.* (*In re El Paso Refinery*) 171 F.3d 249, 253 (5th Cir. 1999) [the trustee must establish that the creditor received a greater percentage on its debt than it would otherwise have received from the Chapter 7 estate].

However, courts often seem to relieve the trustee of this burden and place it on the preference creditor-defendant. Lien or bond creditors are given the burden of proving that the estate was not diminished when the case is decided on a Contemporaneous Exchange of New Value defense,[227] as are most inchoate lien or payment bond preference cases. The burden of proof is on the preference creditor-defendant to demonstrate existence of this affirmative defense.[228]

Whether the trustee or the defendant creditor has the burden of proof is often critical in a mechanic's lien or bond preference case, given the difficulty of developing third party evidence of the funds held by owners and general contractors at the time of a payment two years earlier. The rules applied to determine whether a payment is preferential also differ.

The relative burden of proof in mechanic's lien and bond preferential transfer cases has always been in question. The same set of facts can present both a §547(b) trustee burden issue and a §547(c) affirmative defense. It may depend on how the issue is framed by the parties or the court.[229] It does seem clear that if the issue is characterized as whether "the creditor received more than it would have under a Chapter 7 liquidation," then it is a §547(b) trustee *prima facia* burden issue. If the issue is characterized as whether "the creditor provided new value," then it is §547(c)

Under the earlier Bankruptcy Act, it was unquestionable that a transfer had to diminish the estate to be avoided as preferential. *See Nat'l Bank of Newport v. Nat'l Herkimer County Bank*, 225 U.S. 178, 184, 32 S. Ct. 633, 56 L. Ed. 104 (1912) ["It is not the mere form or method of the transaction that the act condemns, but the appropriation by the insolvent debtor of a portion of his property to the payment of a creditor's claim, so that thereby the estate is depleted and the creditor obtains an advantage over other creditors"]; *Bailey v. Baker Ice Machine Co*., 239 U.S. 268, 274, 36 S. Ct. 50, 60 L. Ed. 275 (1915) ["It therefore is plain that §60b [of the Bankruptcy Act] refers to an act on the part of a bankrupt whereby he surrenders or encumbers his property or some part of it for the benefit of a particular creditor and thereby diminishes the estate which the Bankruptcy Act seeks to apply for the benefit of all the creditors"].

In 20-plus years of precedent, the Sixth Circuit has retained this element, holding that to satisfy §547(b) a trustee must show that the alleged preferential transfers diminish the estate available to unsecured creditors. *See Chase Manhattan Mortgage Corp. v. Shapiro* (*In re Lee*), 530 F.3d 458, 464 (6th Cir. 2008) ["Although §547(b) does not expressly make diminution of the estate an element of a preference claim, diminution is understood to be a requirement as a result of §547(b)(5)'s improvement-in-position test"]; *Stevenson v. Leisure Guide of America, Inc. (In re Shelton Harrison Chevrolet, Inc.)*, 202 F.3d 834, 836-37 (6th Cir. 2000) ["Specifically, the bankruptcy trustee may avoid any transfer of the debtor's property to a creditor ... that diminishes the estate"] (internal quotation marks omitted); *McLemore v. Third National Bank (In re Montgomery)*, 983 F.2d 1389, 1394 (6th Cir. 1993) ["We agree, of course, that a voidable preference necessarily depletes the debtor's estate; without such a depletion, there cannot be a voidable preference"]; *Waldschmidt v. Mid-State Homes, Inc. (In re Pitman)*, 843 F.2d 235, 238 (6th Cir. 1980) [§547(b) "declares that the bankruptcy trustee 'may avoid any transfer' of the debtor's property to a creditor 'for or on account of an antecedent debt owed by the debtor before such transfer was made' that diminishes the estate or creates an inequality among classes of creditors"].

In its 2008 opinion in *In re Lee,* the Sixth Circuit could not have been clearer that diminution of the estate is a necessary element of §547(b). There the court wrote, "[t]he concept here is the same as the idea developed in old Supreme Court opinions under old bankruptcy acts—that a voidable preference must 'impair,' or 'diminish,' the estate." *In re Lee,* 530 F.3d at 464. Although not as explicit, the Eleventh Circuit has also deemed it necessary under §547(b) to analyze whether an alleged preferential payment diminished the estate. In *Bank of America N.A. v. Mukamai* (*In re Egidi*), 571 F.3d 1156 (11th Cir. 2009), the Eleventh Circuit extensively analyzed the effect of a transfer on the debtor's estate, to determine whether the bankruptcy trustee had satisfied §547(b). *Id.* at 1161. The court ultimately determined that "[b]ecause the transfer was within the control of ... the debtor, and the transfer diminished the assets in the estate available to other creditors, the transfer was a preference, which could be avoided by the trustee." *Id.* at 1162.

Similarly, the Eighth Circuit in *Wells Fargo Home Mortgage, Inc. v. Lindquist*, 592 F.3d 838 (8th Cir. 2010), performed an analysis of whether the alleged preferential transfer diminished the estate to determine whether §547(b)(5) was satisfied. *Id*. at 844-45. Ultimately the court concluded that "the transfer of the mortgage to [creditor] diminished the bankruptcy estate" and affirmed the holding of the bankruptcy court that the trustee had satisfied §547(b)(5). *Id.* at 845.

The Fifth, Seventh and Tenth Circuits also continually include diminishment principles in §547(b) elements. *See Caillouet v. First Bank & Trust* (*In re Entringer Bakeries Inc.*), 548 F.3d 348 (5th Cir. 2008) [the earmarking doctrine is based on the concept that the transfer "in no way diminishes the debtor's estate"]; *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 135 (5th Cir. 1986) ["For the preference to be voided under Section 547, it is essential that the debtor have an interest in the property transferred so that the estate is thereby diminished"] (internal quotation marks omitted); *Warsco v. Preferred Technical Group*, 258 F.3d 557, 564 (7th Cir. 2001) ["[c] ourts considering [§547(b)] have focused on whether the transfer diminished the debtor's estate"]; *In re Smith,* 966 F.2d 1527, 1535 (7th Cir. 1992) ["But courts have also long held that to be avoidable, transfers must result in a depletion or diminution of the debtor's estate"]; *Parks v. FIA Card Services, N.A. In re Marshall*), 550 F.3d 1251, 1257-58 (10th Cir. 2008) [considering whether the estate was diminished in determining whether §547(b) was satisfied].

The question remains whether diminution of the estate remains a trustee burden issue and whether the transfer must be compared only to payment as a general unsecured creditor in a direct distribution from the bankruptcy estate. The Sixth Circuit has declared that diminution remains an element. The Fifth, Sixth, Seventh, Eighth, Tenth and Eleventh Circuits similarly continue to apply the concept of diminishment of the estate to §547(b). The Fourth and Ninth Circuits have found §547(b) satisfied when the estate would not be diminished by the transfers.

[227] 11 U.S.C. §547(c)(1).

[228] 11 U.S.C. §547(g) (2009)*; In re J.A. Jones, Inc*, 361 B.R. at 99, *citing Hager v. Gibson*, 109 F.3d 201, 210 (4th Cir. 1997).

[229] *See O'Rourke v. Coral Construction, Inc.* (*In re E.R. Fegert, Inc.*), 88 B.R. 258 (BAP 9th Cir. 1988) (where the parties "stipulated that the elements of a preference set out in Section 547(b) existed").

creditor burden affirmative defense. Whether the debtor's estate was diminished is a consistent element, but it can be critical who has the burden of proof on this issue.

The court case law is somewhat in conflict whether the discharge of inchoate liens or payment bonds by a transfer payment invokes the trustee's burden of proof or the creditor' affirmative defense. Cases are sometimes clear that the trustee has the burden. This is most certainly true for a lien on funds or a lien on real estate owned by the debtor, since this is a security interest in property of the estate.[230]

The burden of proof in cases involving release of payment bonds or mechanic's liens in non-debtor real estate is not as consistent. Most cases simply do not discuss the relative burdens or how to determine those burdens, stating only the conclusion that a payment was preferential or not. Many treat the issue as a "below the line" new value affirmative defense, while others indicate that these are "above the line" matters on which the trustee has the burden.[231]

It does seem that the release of payment bonds or mechanic's liens should be "above the line" matters and that the trustee has at least the initial burden. The trustee should need to show that the transfers were more than the creditor would have received in a Chapter 7 liquidation and that the estate was diminished.

This may be a case of "shifting burdens." Perhaps, once the trustee shows that unsecured creditors would receive no distribution in a hypothetical Chapter 7, the burden may shift to the defendant to show that mechanic's liens or payment bonds applied to the work and perhaps that the time for perfection had not expired at the time of the transfers. It is not so clear at this point whether the trustee or the defendant has the burden of proving the value of those liens or bonds.

It does seem clear that once there is undisputed evidence that mechanic's liens or bonds applied to the work, that the time for perfection had not expired at the time of the transfers and that there were sufficient funds owed to debtor at or after the transfers, then the burden must shift back to the trustee to prove that there were other claimants to those funds that would result in a diminution of the estate. This information is peculiarly in the trustee's, and not the defendant's possession. The debtor knows what other subcontractors and suppliers it hired on the project, the dollar amount owed to them and the dollar amount the debtor claimed due from each owner or general contractor. It is difficult or impossible for a preference defendant to get this information, except from the debtor. The creditor cannot prove the nonexistence of other claimants. The trustee must have the burden of proving diminution of the estate.

The Indirect Transfer Theory and Triangulation

Set off rights and subrogation rights provide a creditor a secured claim under the Bankruptcy Code.[232] The set off rights of an owner or the general contractors and the subrogation rights of the bonding companies can provide a secured claim for a lien or bond creditor on an indirect transfer theory. The indirect transfer theory can be asserted in a §547(b)(5) trustee burden issue or a §547(c)(1) affirmative defense.[233] This is an important feature of a preference cases with mechanic's liens in non debtor real estate or payment bonds in trustee burden issues[234] or affirmative defenses.[235]

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[230] *See In re J.A. Jones, Inc.,* 361 B.R. at 101, n.6; *In re Electron Corp.,* 336 B.R. 809 (BAP 10th Cir. 2006); *see In re JKJ Chevrolet,* 412 F.3d at 551; *see also In re Smith's Home Furnishings,* 265 F.2d at 964.

[231] *In re 360 Networks (USA), Inc.*, 327 B.R. 187, 189 (Bankr. S.D.N.Y. 2005); *In re Abatement Environmental Resources, Inc.*, 307 B.R. 491 (Bankr. D. Md. 2004); *See In re Askenaizer*, 2007 U.S. Dist. LEXIS 24632 at * 6-7 (D.N.H. 2007) [where the Bankruptcy Court found in a lien and bond preference case that "the preference transfer test set forth in 11 U.S.C. §547(b)(5) [was] not met, and declined the Trustee's request to avoid them." *Id.* at *5 The District Court remanded for a finding on "what the creditor, Seacoast, got paid, and what it (or its subrogee) would have been paid in a Chapter 7 proceeding." *Id.* *13]; *See In re Askenaizer*, 391 B.R. 7 (Bkcy D.N.H. 2007) [where the Bankruptcy Court on remand found that the owner "would have had a fully secured indemnity claim if the Debtor defaulted" but for some reason changed theories, stating that the "release of lien rights conferred 'new value' to the debtor in a substantially contemporaneous exchange and the Payments cannot be avoided under Section 547(b)]. *Id.* at 11-12.

[232] 11 USC 506(a)(1) defines secured status in bankruptcy and states:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to set-off under Section 553 of this title [11 USCS §553], is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to set-off, as the case may be.

[233] *In re J.A. Jones, Inc.*, 361 B.R. at 102, n. 7, *citing In re Mason and Dixon Lines, Inc.,* 65 B.R. 973, 979 (Bankr. M.D.N.C. 1986).

[234] *Field v. Insituform East, Inc.* (*In re Abatement Environmental. Resources, Inc.*), 307 B.R. 491 (Bankr. D. Md. 2004).

[235] The new value exception may be satisfied by an indirect transfer of value via a third-party to a debtor rather than a direct transfer of value from creditor to debtor. *Holmes Envtl. v. Suntrust Banks* (*In re Holmes Envtl., Inc.*), 287 B.R. 363, 386-387 (Bankr. E.D. Va. 2002), *citing Lubman v. C.A. Guard Masonry Contractor, Inc.* (*In re Gem Construction Corp. of Virginia, Inc.*), 262 B.R. 638, 646 (Bankr. E.D.Va. 2000); *See also In re Lockwood Greene Eng., Inc. v. Binsky & Snyder, Inc.* (*In re J.A. Jones, Inc.)*, 361 B.R. 94, 102-03 (Bankr. W.D.N.C. 2007).

It is an established rule that a creditor is 'secured' only to the extent of the value of his interest in property of the estate."[236] The essence of the indirect transfer theory is that the creditor could obtain payment from a third party (either from the property owners, the general contractors or the bonding company through mechanic's liens or bonds). These third parties are then secured by property of the estate, such that the transfers to the creditor "had the effect of releasing assets of comparable value to the claims of general creditors." The transfer payments are not preferential because "they do not deplete the debtor's estate or diminish the assets available for distribution among general creditors."[237]

The indirect transfer theory has been adopted by many bankruptcy, district and circuit courts and has not been rejected by any court. If the indirect transfer theory is viable, it is not relevant whether the creditor had a security interest at the time of the transfers or only contract rights.[238] It is not relevant whether the preference creditor-defendant had actually perfected mechanic's liens or bonds.

An indirect transfer theory recognizes that the preference defendant does not have a security interest in assets of the bankruptcy estate. However, if the transfer had the effect of releasing a claim against a bond surety or owner or general contractor that had a security interest in assets of the bankruptcy estate, then no preference has occurred.

For example, a material supplier ships product to a construction project. The general contractor makes payment, but then becomes insolvent and files bankruptcy. In a later preference analysis, the question becomes whether the supplier could have filed a mechanic's lien at the time of the transfer payment on the non-debtor real estate (the general contractor is the debtor in bankruptcy). After the supplier received the transfer payment, did the owner of the real estate owe enough money to the general contractor that the owner could have set off the supplier mechanic's lien amount against the amount owed the general contractor. If the supplier's mechanic's lien had value, then the indirect transfer of security rights means that debtor is no worse off and the creditor is no better off as a result of the transfer payment. These are the concepts of triangulation and value.

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[236] *Smith v. Creative Fin. Mgmt., Inc.* (*In re Virginia-Carolina Fin. Corp.*), 954 F.2d 193 (4th Cir. 1992). In *Smith v. Creative Financial Management, Inc.,* however, the debt paid with the preference transfer was collateralized by a promissory note from a non-debtor and secured in non-debtor property. In other words, the transfer did diminish the bankruptcy estate, even though the defendant could accurately state that it was fully secured (in non-debtor property) and would have been paid in a Chapter 7 liquidation.

[237] *Small v. Williams*, 313 F.2d 39, 44 (4th Cir. 1963).

[238] The Fifth and Ninth Circuits have held that transfer payments that automatically released mere contract rights against a third party that simultaneously released the security rights or contingent claims of that third party against assets of the estate were not were not preferential.

The Fifth Circuit has held that the value of the debtor's estate was not diminished in an indirect transfer. The Court allowed a contemporaneous exchange defense when the preference defendant had unsecured contract claims against a line of credit bank, which had security rights in the debtor's assets. The Fifth Circuit assumed that "[u]pon Bankruptcy, had [the debtor] not performed, the [preference defendant] would have drawn on the letters of credit and the Banks would have been entitled to the collateral or its value." *Gulf Oil Corporation v. Fuel Oil Supply & Terminaling, Inc.* (*In re Fuel Oil Supply & Terminaling, Inc.*), 837 F.2d 224, 229 (5th Cir. 1988).

The Ninth Circuit came to the same result, also ruling there was an "automatic release of collateral," stating that:

The Fifth Circuit held that the payment was protected by the contemporaneous exchange for new value exception, reasoning that, when the debtor paid the creditor, the banks' exposure under the letters of credit was reduced by a corresponding amount. The banks' *contingent* reimbursement claim against the debtor's assets *was thereby released, giving the debtor new value*. "This outcome is consistent with the principle underlying §547(c)(1)," the Fifth Circuit noted, "*because the release of the debtor's collateral offsets the transfer to the creditor, thereby resulting in no depletion to the debtor's estate." Id.* [*citing In re Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d at 228]; *see also In re E.R. Fegert, Inc*., 887 F.2d 955, 959 (9th Cir. 1989).

When [the debtor] paid [preference defendant] directly, [the bank's] exposure under the letters of credit was reduced by a corresponding amount, and its *contingent claim* against [the debtor's] assets *was thereby released*, but only to the extent the claim was secured. Thus, [the debtor] received new value equal to the amount of the secured portion of [the bank's] reimbursement claim.

Committee of Creditors Holding Unsecured Claims v. Koch Oil Company (*In re Powerine Oil Company*), 59 F.3d 969, 973 (9th Cir. 1995) (emphasis added).

The Ninth Circuit's decision in *Fegert* used an indirect transfer theory with a payment bond surety. In *United Rentals, Inc. v. Angell*, 592 F.3d 525, 532 (4th Cir. N.C. 2010), however, the Fourth Circuit distinguished *Fegert* by stating that "[s]ince [the defendant] never even attempted to make any claim on the bond here, the Surety never obtained any lien that it could release."

It is true that the both the debtor and surety paid a portion of a bond claim in *Fegert*. However, the payment by the surety would not affect the Court's analysis. The *Fegert* Court was well aware that only if a surety "*pays* subcontractors and materialmen, that surety has a subrogated right to contract balances." *In re E.R. Fegert, Inc.,* 887 F.2d at 959 (emphasis added). If the only question was whether the surety actually possessed an equitable lien to be released at the time of the transfers were made, the outcome in *United Rentals, Inc. v. Angell* and *Fegert* would be the same.

The *Fegert* Court stated that "if [debtor] had not paid [claimants] in full, those subcontractors would have been paid by [the surety], and [the surety] *would then have had* an equitable lien against the contract balance ... By paying the subcontractors, [debtor] *avoided* [the surety's] automatic and equitable lien. This constituted 'new value' ... " *Id.* (emphasis added).

Triangulation and Valuation

If a secured lender has a security interest in property of the debtor, there is no need for triangulation or an indirect transfer theory. The preference creditor-defendant has a security interest directly in property of the debtor that is automatically discharged when the debtor makes the transfer payment. However, there is still an issue whether the security interest had any value. If the security interest was worthless, the payment will still be a preference. This problem could arise, for example, if the security property had no value or had been destroyed.

In a construction-contracting context, it is relevant whether mechanic's liens have value, even if the debtor was the owner of the real estate.[239] In other words, this security property might have no value or been destroyed. Also, if the time to perfect the mechanic's lien had expired before the creditor received money, then the payment is still a preference. Even if the debtor demanded a mechanic's lien release and even if both debtor and creditor thought it had value, the release was actually worthless. The transfer did not simultaneously augment a debtor asset (by increasing debtor's equity in the collateral). A net depletion of assets occurred and the bankruptcy estate was diminished for distribution to general unsecured creditors.

A similar issue can exist in states with a "defense of payment" to a mechanic's lien.[240] This is discussed in greater detail in other chapters of the book, but in such states the mechanic's lien of a subcontractor or supplier will only be enforceable if the owner is still holding money on the general contractor, the general contractor is still holding money on the subcontractor, etc. Once the owner has paid in full for the project, no mechanic's lien could be enforced on the property. In defense of payment states, the release or discharge of a mechanic's lien is also worthless if the owner has already paid for the project.

This defense of payment issue introduces the concept of "triangulation." Now we have three parties and an indirect transfer in the transaction. The issue is still whether the bankruptcy estate was diminished by the transfer payment to the creditor. Unless the transfers by the debtor diminish the estate of the debtor, the creditor cannot be charged with a preference.[241] If the owner was holding money on a general contractor *and* had the right to withhold the money for a mechanic's lien, then the payment to the creditor did not diminish the estate. If the debtor had not paid the creditor, the creditor could have filed a mechanic's lien, the owner could have withheld money from the debtor and the debtor would end up with the same amount of money. In other words, the bankruptcy estate would have had the same amount of money to distribute to general unsecured creditors whether this allegedly preferential payment was made to this creditor or not.

This is obviously much simpler if the bankrupt debtor was the owner of the property. There is no need to prove triangulation. As long as the real estate had sufficient value and the creditor was still in time to file a mechanic's lien, the bankruptcy estate was not diminished. The creditor would have had a mechanic's lien *in the property of the debtor*. Exchanging these mechanic's liens for payment cannot be a preference.[242] This would constitute both an "above the line" argument and a "below the line" defense.[243] The creditor will obviously have an easier time if successful in making this an "above the line" argument where the trustee has the burden of proof, especially where so much evidence will be necessary.

This triangulation and valuation analysis also becomes very important in cases involving bond releases. A creditor and debtor may both actually intend to trade a payment for a bond release. The creditor may still have plenty of time to enforce payment through the bond. However, the question still remains whether this payment diminished the bankruptcy estate.[244]

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[239] *Smith v. Creative Management, Inc*. (*In re Virginia-Carolina Fin. Corp*.), 954 F.2d 193 (4th Cir. 1992).

[240] *See* chapter, Mechanic's Lien Rights and General Principles.

[241] *National Bank of Newport, NY v. National Herkimer County Bank of Little Falls*, 225 U.S. 178, 184, 32 S. Ct. 633, 635 (1912); *see also Continental & Commercial Trust & Sav. Bank v. Chicago Title & Trust Co.*, 229 U.S. 435, 33 S. Ct. 829 (1913); *Small v. Williams*, 313 F.2d 39, 44 (4th Cir. 1963); *Virginia Nat'l Bank v. Woodson*, 329 F.2d 836, 840 (4th Cir. 1964); *Active Wear, Inc. v. Parkdale Mills, Inc*., 331 B.R. 669 (W.D. Va. 2005).

[242] *Virginia Nat'l Bank v. Woodson*, 329 F.2d 836 (4th Cir. Va. 1964); *Committee of Creditors Holding Unsecured Claims v. Koch Oil Co.* (*In re Powerine Oil Co.*), 59 F.3d 969, 973 (9th Cir. 1995); *In re Robinson Bros. Drilling, Inc.,* 877 F.2d 34; *In re Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d at 231; *Cocolat, Inc. v. Fisher Dev., Inc.* (*In re Cocolat, Inc.*), 176 B.R. 540 (Bankr.N.D.Cal. 1995).

[243] *See* subsection above, The Trustee's Burden of Proof; sub-subsection, Secured Creditors.

[244] *In re E.R. Fegert, Inc*., 88 B.R. 258 (9th Cir. 1988), *aff'd In re E.R. Fegert, Inc. II*, 887 F.2d 955, 9th Cir. 1989; *In re Powerline Oil*, 59 F.3d 969 (9th Cir. 1995); *In re JWJ Contracting Co*., 287 B.R. 501 (9th Cir. 2002); *In re Jones Construction*, 337 B.R. 579, 583 (Bankr. E.D.Va. 2006); *In re Gem Const. Corp. of Virginia*, 262 B.R. 638 (E.D.Va. 2000); *Field v. Insituform East, Inc.* (*In re Abatement Environmental Resources, Inc.*), 307 B.R. 491 (Bankr. MD 2004); *Newberry v. Fireman's Fund*, 106 B.R. 186 (D. Ariz. 1989).

Again, this analysis is easier if there are fewer parties involved, although all bond cases will involve at least three parties, triangulation and an indirect transfer. If the debtor was the principal on the bond[245] *and* the bond company had subrogation rights or a security interest on assets of the debtor, then triangulation and value exist and the payment was not a preference. If the payment was not made, the creditor could have enforced payment from the payment bond. The bonding company could have then enforced its interest on the assets of the debtor, pulling that amount of money out of the pool available for distribution to general unsecured creditors. The bankruptcy estate was not diminished.

This analysis gets a little more difficult if the debtor was not the bond principal. Let's say you are supplying material on a government project to a subcontractor, but the prime contractor bonded the project. Your subcontractor customer files bankruptcy within 90 days after giving you payment on an old invoice. You may have had the ability to enforce the bond against the prime contractor and bonding company at the time of payment. In order to use this as a preference defense, however, you will have to show first that you had that ability, but also that the general contractor was still holding money on your subcontractor customer at the time the debtor paid you.[246] If you had made your bond claim, the prime would have refused to pay the subcontractor, paid you on the bond, and then set-off this amount against the debtor. The bankruptcy estate was not diminished. On the other hand, if the prime contractor had already paid the subcontractor, there is no value. The payment by the sub did diminish the estate, even though you could have enforced against the bond at the time you received the payment.

The burden of proof becomes particularly important on these "valuation" issues. A remote supplier can actually end up in the difficult position of trying to prove, two years after the fact, that the owner was holding enough money on the general contractor *and* that the general contractor was holding money on the debtor-subcontractor at the time the supplier was paid. Developing this proof will be difficult in any event, but it will be impossible if the creditor has no information on the project or the owner. This again illustrates the importance of collecting project information in any case and especially once a debtor has filed bankruptcy. It also emphasizes the importance of determining whether the trustee or the preference creditor-defendant has the burden of proof.

If triangulation and value did not exist, the payment was still a preference, even though the creditor had a perfectly good bond at the time. This can have diseconomic and fairly ridiculous results. A creditor may supply materials to a bonded project but may have concerns about the debtor's solvency. The creditor has no way to know at that point whether the parties involved would have the ability to pull this money out of estate in the event of bankruptcy and whether a payment would diminish a future bankruptcy estate. There are only three ways this creditor can be safe. One way is to refuse payment from the debtor and insist on payment directly from the bonding company or owner. Another choice is to enforce against the bond even though they have been paid. A third possibility is an agreement from the bonding company giving you more time to make your bond claim, in the event of a preference claim two years later. All of these choices have obvious problems.

Unfortunately, you do not know now whether those property owners or bonding companies had recourse against the debtor's property. If the bonding company had no recourse, you may need to repay this money as a preference two years from now, even though you could have enforced your rights against the bonding company now at the time of payment. Two years from now, when the preference claim is brought against you, it will be too late to enforce your bond rights. This can put you in the ridiculous position of enforcing the bond once your debtor files bankruptcy for money you have actually already been paid. This may be the only way to make sure you get to keep this money, however. This decision is a little easier to make if you are still owed money on a project and will be making a bond claim in some amount anyway.

You could make a bond claim or assert mechanic's liens, stating that you make your claim only if the debtor later makes a preference claim against you. You can agree with the bonding company to leave the lawsuit pending and not spend any time on it unless and until the trustee makes a preference claim against you. The bonding company may also agree to give you evidence that they were secured in the debtor's property and that the debtor's payment to you did not diminish the estate. The bonding company may agree to pay you if you agree to simultaneously pay back the same amount of money you received from the debtor. I am not trying to tell you this is logical. Logic has nothing to do with it. You will just need to decide from a business point of view how much money you have at risk and whether it is worth going through some of these gyrations to protect yourself.

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[245] *See* chapter, Performance and Payment Bonds.

[246] As discussed below, under *United Rentals, Inc. v. Angell*, 592 F.3d 525 (4th Cir. N.C. 2010), the payment would still be a preference unless the preference creditor-defendant had also actually made a bond claim.

Some bonding company is sure to make the argument that you have no bond claim now for money that you have already been paid, even though it will be too late to make a bond claim later if you get unpaid. It is not clear what would happen with this argument. The only way to avoid this problem, however, is to refuse money from any debtor that might go into bankruptcy and insist on making your mechanic's lien or bond claim instead. We are clear that you would always prefer to get paid by the property owner's bonding company instead of the debtor,[247] but it is an obvious problem to refuse payments from your debtor. It is always important to be careful with lien and bond claim waivers, to make sure your security rights are not waived if a preference claim is brought against you later. This is discussed in other chapters of this book.[248]

After bankruptcy you should deal in the same manner with your (1) uncollected receivable and (2) all money received during the preference period. "Spread" the invoices to figure out where all the material went and whether you have security rights for uncollected receivable and for payments received shortly before the bankruptcy filing.

It is often a good strategy to force the debtor and bankruptcy trustee to litigate the preference case early in a bankruptcy, while you still have liens or bonds to protect you. Bring the debtor, the bankruptcy trustee, the project owner, general contractor and the bonding company into the bankruptcy court early. Litigate the preference and your bond claim simultaneously with all parties in one courtroom. These parties may be helpful now in proving you had security and forcing the debtor to resolve a preference claim, but this help may not be available two years from now.

There is no doubt that the U.S. Congress and bankruptcy courts struggle with a difficult battle between innocents in determining bankruptcy law. It is respectfully submitted, however, that Congress should amend the preference statute to clarify that it is *not* necessary for a creditor to prove triangulation in order to have a new value defense to a preference action. It does make sense to require a creditor to prove that it was still within time to file a mechanic's lien or payment bond claim at the time payment was received. If a creditor could prove that it could have forced payment from *anyone*, however, this should constitute a defense to a preference action. At a minimum, the preference plaintiff (trustee or debtor) should have the burden of proof that the payment diminished the estate.

Creditors are never in a position to know whether the bonding company on the project has a security interest in the assets of the debtor, whether the general contractor is still holding money on the subcontractor customer, or whether there is other recourse against the bankruptcy estate. Since they will never have this information, the only safe course for a creditor is to refuse payment from a debtor, insist on filing mechanic's liens or bond claims and demanding payment directly from an owner or bonding company. The only other choice is to enforce mechanic's liens or bonds even though they have been paid in full. This generates unnecessary legal fees and frustration on construction projects. The law should not force or encourage this type of diseconomic activity.

The moral to this story for creditors is to always get payment from someone other than the debtor, if there are concerns about insolvency. If payments are received from an owner or a bonding company, the payment cannot be a preference.[249] The new value defense will also be stronger if the creditor actually filed a mechanic's lien or made

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[247] In *Keenan Pipe & Supply Co. v. Shields*, 241 F.2d 486 (9th Cir. 1956); *Texas American Bancshares, Inc. v. Clarke,* 954 F.2d 329 (5th Cir. 1992); *see also DeAngio v. DeAngio*, 554 F.2d 863 (8th Cir. 1977); *Downriver Comm. Fed. Credit Union v. Penn. Square Bank*, 879 F.2d 754 (10th Cir. 1989), *cert. denied,* 493 U.S. 1070, 110 S. Ct. 1112 (1990).

[248] *See* chapter, Contract Terms and Preserving Rights; section, Contract Administration; subsection, Waiver Forms.

[249] In *Keenan Pipe & Supply Co. v. Shields*, 241 F.2d 486 (9th Cir. 1956), a Bankruptcy Trustee unsuccessfully argued that the supplier receiving payment directly from the general contractor was effectively collecting on the debtor's accounts receivable, diminishing the value of the estate. *Id*. at 490. The court dismissed that argument as "erroneous ... as the check never entered the estate of [the debtor]" "[I]f the prime contractor or the subcontractor dedicates a specified sum to pay the laborer or materialman to discharge the obligation place upon the contractor ... no one else can assert any claim to money so paid." *Id*. at 489. The pool of funds from which unsecured creditors may recover was not diminished. If it was the obligation of the general contractor to see that the material bills were paid, and he paid them directly, "that is no concern of the Trustee. By no devise can it be conceived that these moneys entered the estate of [the debtor]." *Id* at 490.

See Texas American Bancshares, Inc. v. Clarke, 954 F.2d 329 (5th Cir. 1992) ["payment to a creditor of an insolvent estate by a source other than the estate does not create a preference and any equal treatment required is based upon the creditor's share of the estate, not on benefits received from the collateral source"]; *see Brown v. First Nat'l Bank of Little Rock, Ark.*, 748 F.2d 490 (8th Cir. 1984) ["payments made to a debtor's creditors by an endorser, surety, guarantor, or payor in a business relationship with the debtor are not preferences because there is no transfer and resulting diminution of the debtor's estate"]; *see also DeAngio v. DeAngio*, 554 F.2d 863 (8th Cir. 1977); *Downriver Comm. Fed. Credit Union v. Penn. Square Bank*, 879 F.2d 754 (10th Cir. 1989), cert. denied, 493 U.S. 1070, 110 S. Ct. 1112 (1990).

A transfer is a preference only if the property transferred belongs to the debtor; if the transfer is made from money of third person to creditor of debtor, or to debtor with instructions to pay off another creditor, that is not avoidable preference. *In re Van Huffel Tube Corp*. 74 BR 579 (N.D. Bankr. Ohio 1987).

Ellenberg v. First Nat'l Bank, 15 B.R. 858 (N.D. Bankr. GA 1981). *See Collier on Bankruptcy* §547[2] (15th Edition Revised, Mathew Bender 2001).

a bond claim before receiving payment.[250] The defense will also be easier to prove if the creditor can produce the release provided in exchange for payment. These are all documents that a creditor should locate and carefully store soon after bankruptcy is filed, in anticipation of a later preference action. In any event, a creditor should never let mechanic's liens or payment bonds expire. This is a very risky practice, because the creditor *may never* be paid and be completely unable to force payment. On top of this, payments actually received may have to be paid back as preferences.

Mechanic's Lien Rights in Non-Debtor Real Estate

If the bankrupt debtor was not the owner of the property, the creditor is in a different preference situation. The contractor may have a mechanic's lien in property, but it is not property *of the debtor*.

At a minimum, the contractor may need to prove "triangulation" and value, as discussed above. In short, the contractor may need to prove that if it had enforced the mechanic's lien, the owner of the property could have withheld money from the debtor and that the bankruptcy estate was not diminished.

However, the bigger issue is whether the trustee has the burden of proof of proving that the preference creditor-defendant would not have received the same payment in a Chapter 7 liquidation and that the bankruptcy estate was diminished. The creditor can end up in the same place using this release of mechanic's liens argument as a "contemporaneous exchange" defense, as is discussed below.[251] Because of the difficulties developing evidence in a preference case, however, it is normally important whether the trustee or the defendant creditor has the burden of proof.

There are court cases suggesting that the preference creditor-defendant would have the burden of proof, since this is a "below the line" defense.[252] Other cases support the view, however, that this is an "above the line" issue on which the trustee has the burden of proof.[253] The creditor's mechanic's lien did provide an interest in the receivable owed to the debtor and held by the real estate owner. This could be viewed as a security interest in property of the debtor (receivable) that the creditor could have enforced in a Chapter 7 liquidation.

More importantly, federal courts have consistently determined that a claimant has the right post-petition to perfect a mechanic's lien in states with an inchoate lien (that relates back).[254] The creditor would not improve its position by filing a mechanic's lien, during the preference period or post petition. The creditor *always had* the secured mechanic's lien. If the creditor's inchoate lien rights prevail over the trustee post petition, how could the trustee

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[250] *United Rentals, Inc. v. Angell*, 592 F.3d 525 (4th Cir. N.C. 2010).

[251] *See* subsection below, Defenses to a Preference Action; sub-subsection, Contemporaneous Exchange for New Value; sub-sub-subsection, Release of Mechanic's Lien or Bond Rights.

[252] *Lubman v. C.A. Guard Masonry Contractor, Inc.* (*In re Gem Construction Corp. Of Virginia, Inc.*), 262 B.R. 638, 646 (Bankr. E.D.Va. 2000); *See also In re Lockwood Greene Eng., Inc. v. Binsky & Snyder, Inc.* (*In re J.A. Jones, Inc*.), 361 B.R. 94, 102-03 (Bankr. W.D.N.C. 2007); *Brown v. Callaway Bank*, 7 B.R. 876 (Bankr.W.D. Mo. 1980).

[253] *R.M. Taylor, Inc. v. H. M. White, Inc.*, 257 B.R.289 (Bankr.W.D. Mo. 2000).

[254] *Concrete Structures, Inc. v. Tidewater Crane and Rigging Co.* (*In re Concrete Structures, Inc.*), 261 B.R. 627, 640-41 (E.D.Va. 2001) ["the recording of a memorandum of lien does not violate the stay imposed by §362(a)"]; *H.T. Bowling v. Bain* (*In re Bain*), 64 B.R. 581 (W.D.VA. 1986). *See also* 98 A.L.R. 32.

Schafer v. Carolina Kitchen & Bath, Inc. (*In re Orndorff Constr*.), 394 B.R. 372, 375-76 (Bankr. M.D.N.C. 2008) [Pursuant to Section 362(b)(3), a bankruptcy petition "does not operate as a stay ... of any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee's rights and powers are subject to such perfection under Section 546(b)."]; *but see In re Shearin Family Investments, LLC*, Case No. 08-07082-8-JRL (Bankr. E.D.N.C., April 17, 2009).

An action to perfect a materialman's lien is excepted from the automatic stay by Section 362(b)(3*). In re Richardson Builders, Inc*., 123 B.R. 736, 738 (Bankr. W.D. Va. 1990); *Victoria Grain Co. of Minneapolis v. Janesville Elevator Construction, Inc.* (*In re Victoria Grain Co. of Minneapolis*), 45 B.R. 2, 6 (Bankr. Minn. 1984) ... But Section 546(b)(1) and (2) limit the trustee's ability to avoid liens pursuant to Sections 544 and 545. Section 546(b)(1)(B) provides that "[t]he rights and powers of a trustee under §§544, 545 and 549 of this Title are subject to any generally applicable law that provides for the maintenance or continuance of perfection of an interest in property to be effective against an entity that acquires rights in such property before the date in which action is taken to effect such maintenance and continuation." *See Cook*, 384 B.R. at 288 (state mechanic's lien law is "generally applicable law" within the meaning of §546(b))].

Yobe Elec. Co., Inc. v. Graybar Elec. Co., Inc. (*In re Yobe Elec., Inc.*), 728 F.2d 207, 208 (3d Cir. 1984) [filing of mechanic's lien against debtor who has filed Chapter 11 petition for work performed for debtor prior to filing of petition does not violate the automatic stay provisions of 11 USCA §362].

In Arkansas, the bankruptcy court found that pursuant to the relation back provision of the mechanic's lien, a properly perfected mechanic's lien on debtors' property was entitled to relief from automatic stay in order to exercise its rights in debtors' property. *In re McCord*, 219 B.R. 251, 253-53 (E.D. Ark. 1998). In Alabama, the bankruptcy court found that a party "could maintain and perfect its mechanic's lien outside bankruptcy and without automatic stay relief." *In re Cook*, 384 B.R. 282, 288 (N.D. Ala. 2008).

avoid a pre-petition payment in discharge of that inchoate lien?[255] The pre-petition payment is not more than this creditor would have received in a subsequent Chapter 7 liquidation. The trustee should have the burden of proving otherwise, based on lack of value or diminution of the estate.

Payment Bond

What if a preference creditor-defendant could have forced payment from a bond at the time of a transfer payment?[256] The preference creditor-defendant could say it would have received the same payment in a Chapter 7 liquidation. There should be no preference so long as the transfers did not allow the creditor to receive more than it would have under a Chapter 7 liquidation, the bond had "value" to the estate and the transfer payment did not diminish the debtor's estate.

Payment bonds in a preference case, like the mechanic's lien in non-debtor real estate, involve an indirect transfer, triangulation and value. In short, the contractor may need to prove that if it had forced payment from a bond, the general contractor or the bonding company would have withheld money from the debtor and that the bankruptcy estate was not diminished.

Again the bigger issue is whether the trustee has the burden of proof of proving that the preference creditor-defendant would not have received the same payment in a Chapter 7 liquidation and that the bankruptcy estate was diminished. The creditor can end up in the same place using this release of a payment bond argument as a "contemporaneous exchange" defense, as is discussed below. Because of the difficulties developing evidence in a preference case, however, it is normally important whether the trustee or the defendant creditor has the burden of proof.

There are court cases suggesting that this is an "above the line" issue on which the trustee has the burden of proof.[257] Other cases state that the preference creditor-defendant has the burden of proof, treating the case as a contemporaneous exchange of new value "below the line" defense.

The most recent and highest ranking court decision on the subject, however, rejects the notion that a discharge of a payment bond can present an above the line trustee burden of proof issue, because the "not more than a Chapter 7 distribution test" focuses "not on whether a creditor may have recovered all of the monies owed by the debtor *from any source whatsoever*, but instead upon whether the creditor would have received less than a 100% payout" from the bankruptcy estate.[258] This apparently means that the court must compare the pre-petition transfer to what that creditor would have received directly from the bankruptcy estate as a general unsecured creditor.

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[255] Post-petition perfection of lien rights is permitted, "if under nonbankruptcy law perfection could relate back to defeat the rights of an intervening creditor." *In re WWG Indus., Inc.*, 772 F.2d 810, 814 (11th Cir. 1985). "If a transferee is able to perfect under Section 546(a) and that perfection relates back to an earlier date, then in spite of the filing of the bankruptcy petition, the trustee would not be able to defeat the lien, because the lien would be perfected and enforceable against a bona fide purchaser that purchased the property on the date of the filing of the petition." *Id.*; *See also In re Lionel Corp., et al*, 29 F. 3d 88, 94 (2d Cir. 1994); *In re Marietta Baptist Tabernacle, Inc.*, 576 F.2d 1237, 1240 (5th Cir. 1978).

The House and Senate Reports state that Bankruptcy Code Section 546(b) is not designed to create new rights, but is only designed to protect*, in spite of the surprise intervention of bankruptcy petition,* those whom state law protects by allowing them to perfect their liens or interest as of an effective date that is earlier than the date of perfection*. See* 11 U.S.C. §546(b) (2009); *See also* H. R. Rep. No. 95-595, 95th Cong., 1st Sess. 371-72 (1977); S. Rep. No. 95-989, 95th Cong., 2d Sess. 86-87 (1978). Section 546(b) contemplates a situation such as a mechanic's and materialmen's lien, where perfection has a retroactive effect and cuts off intervening parties. *In re Westchase I Associates, L.P.*, 119 B.R. 521, 526 (W.D. N.C. 1990) (Emphasis added).

The trustee's burden to show that a transfer provided more than a Chapter 7 liquidation and any analysis whether the transfer diminished the estate must have some reference to the established law that an unperfected mechanic's lien is superior to the rights of the trustee and some reference to the post-petition mechanic's lien or bond rights the preference defendant would have enjoyed absent payment.

[256] *O'Rourke v. Coral Construction, Inc.* (*In re E.R. Fegert, Inc.*), 88 B.R. 258, 260 (9th Cir. App. Panel 1988), *aff'd* 887 F.2d 955 (9th Cir. 1989); *see also National Shawmut Bk. of Boston v. New Amsterdam Cas. Co*., 411 F.2d 843, 849 (1st Cir. 1969); *First Ala. Bk. v. Hartford Acc. & Indemnity Co.*, 430 F. Supp. 907, 910 (N. Ala. 1977).

[257] In *Field v. Insituform East, Inc.* (*In re Abatement Environmental. Resources, Inc.*) 307 B.R. 491 (Bankr. D. Md. 2004), the court reasoned that where the collateral held by the indemnified bonding company is "sufficient to fully secure the claim of the creditor receiving or benefiting from the questioned transfer, the creditor is placed in no better position than it would have been in a hypothetical liquidation under Chapter 7. Likewise the estate for unsecured creditors is not depleted because simultaneous with the transfer of the unliened funds out of the estate, the estate receives the transfer by release of creditor's lien upon the collateral." The *In re Abatement* Court held that "if the funds transferred were collateral secured by [the surety's] contingent subrogation lien, no avoidable preference exists…" the creditor was assured to receive 100% payout in a Chapter 7 liquidation and the estate was not diminished. This case may now be overruled, however, by *United Rentals, Inc. v. Angell*, 592 F.3d 525 (4th Cir. N.C. 2010).

[258] *United Rentals, Inc. v. Angell*, 592 F.3d 525, 531 (4th Cir. N.C. 2010), *citing Smith v. Creative Fin. Mgmt., Inc.* (*In re Virginia-Carolina Fin. Corp.*), 954 F.2d 193, 199 (4th Cir. 1992). However, to say that the court must not focus on whether a creditor may have recovered all of the monies "from any source whatsoever," however, does not mean that there is only one source of funds shielded from preference attack, a distribution to general unsecured creditors directly from the bankruptcy estate. The critical question instead should be

If the creditor had perfected or enforced its bond after the bankruptcy petition, however, the bonding company would still have its equitable right of subrogation against the balances owed to the debtor.[259] The equitable lien granted the surety entitles it to precedence over the trustee in bankruptcy of the debtor-contractor.[260] Again, the transfers would not allow the creditor to receive more than it would have under a Chapter 7 liquidation and would not diminish the debtor's estate. The creditor could force the same payment post petition and the creditor, the debtor and the general unsecured creditors would all be in the exact same financial position. If the transfers were not received by the creditor, the surety would have made payment to the creditor for labor or material supplied. The surety would have been entitled to payment directly from the bond obligees (owners or general contractors) based upon its subrogation rights.[261] The surety has an equitable right to "make demand and to receive any balances due under the contracts" from [owners or general contractors].

Courts have stated that the balances held by owners or general contractors would never become property of the debtor's estate. Since the surety's equitable right to these funds relates back to the date of the bond, it entitles the surety "to priority in payment over all subsequent lien holders and general creditors."[262] By "the surety's acquiring this equitable interest in retained funds," those funds become the property interest of the surety and never become a part of the bankruptcy estate "to be administered, liquidated, and distributed to general creditors of the bankrupt."

Like mechanic's liens, the creditor also would not violate the bankruptcy stay by perfecting or enforcing *bonds* after the bankruptcy petition. The bonding company is not the debtor in bankruptcy. There would be no bankruptcy stay. If the creditor had perfected or enforced payment under the bond after the bankruptcy petition, however, the bonding company would still have its equitable right of subrogation against the balances owed to the debtor.[263]

The equitable lien granted the surety entitles it to precedence over the trustee in bankruptcy of the debtor-contractor.[264] Again, the transfers do not allow the creditor to receive more than it would have under a Chapter 7 liquidation and did not diminish the debtor's estate. The creditor could assert the same rights post petition and the creditor, the debtor and the general unsecured creditors would all be in the exact same financial position. The pre-petition payment is not more than the creditor would have received in a subsequent Chapter 7 liquidation. The trustee should have the burden of proving otherwise, based on lack of value or diminution of the estate.

Defenses to a Preference Action

Once the trustee proves that the creditor received a payment for an antecedent debt within 90 days of bankruptcy that enabled the creditor to receive more than it would have in a Chapter 7 liquidation, the burden of proof shifts to the creditor-defendant. Because of the problem with information, discussed above,[265] the shift in the burden of proof to the creditor is important. The creditor that collected information early in the bankruptcy process will have a big advantage.

Subsequent Advance Rule

You may be able to show that you extended new credit to the debtor after receipt of allegedly preferential payments. A creditor can take the position that it would not have extended new credit and would have "cut off" the debtor if the payments were not received. This is known as the "subsequent advance rule."[266]

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whether this particular creditor could have received the same payment in a Chapter 7 liquidation and whether the estate was diminished by the pre-petition transfer.

[259] *See Western Cas.*, 362 F.2d at 492; *In re Jones Constr. & Renovation, Inc.*, 337 B.R. 579, 585 (Bankr. E.D. Va. 2006).

[260] *O'Rourke v. Coral Construction, Inc.* (*In re E.R. Fegert, Inc.*), 88 B.R. 258, 260 (BAP 9th Cir. 1988), *aff'd* 887 F.2d 955 (9th Cir. 1989). The surety could still enforce this equitable right of subrogation post petition. *Tri-City Serv. Dist. v. Pacific Marine Dredging and Constr.* (*In re Pacific Marine Dredging and Constr.*), 79 B.R. 924, 929 (Bankr. D. Ore. 1987).

[261] A surety's "right of subrogation is not founded on contract. It is a creature of equity; is enforced solely for the purpose of accomplishing the ends of substantial justice; and is independent of any contractual relations between the parties." *Western Cas. v. Brooks*, 362 F.2d 486, 490 (4th Cir. 1966) (*quoting Memphis & L.R.R. v. Dow*, 120 U.S. 287, 301-02, 7 S. Ct. 482, 488, 30 L. Ed. 595 (1887)).

[262] *See Western Cas. v. Brooks*, 362 F.2d 486, 490 (4th Cir. 1966).

[263] *See Western Cas.*, 362 F.2d at 492; *In re Jones Constr. & Renovation, Inc.*, 337 B.R. 579, 585 (Bankr. E.D. Va. 2006).

[264] *O'Rourke v. Coral Construction, Inc.* (*In re E.R. Fegert, Inc.*), 88 B.R. 258, 260 (BAP 9th Cir. 1988), *aff'd* 887 F.2d 955 (9th Cir. 1989). The surety could still enforce this equitable right of subrogation post petition. *Tri-City Serv. Dist. v. Pacific Marine Dredging and Constr.* (*In re Pacific Marine Dredging and Constr.*), 79 B.R. 924, 929 (Bankr. D. Ore. 1987).

[265] *See* subsection above, The Information Problem.

[266] 11 U.S.C. §547(c)(4) states that the Trustee may not avoid a payment: [T]o the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—

(A) not secured by an otherwise unavoidable security interest.

To determine the subsequent advance rule credits, a creditor should start with a list of the allegedly preferential payments received. The amount of the first check is the "positive preference balance." This balance is reduced by the amount of new credit extended *after* receipt of this payment. The positive preference balance goes down with each new extension of credit. The positive preference balance then goes up again in the amount of the next allegedly preferential payment received. The positive preference balance then goes down again with extensions of credit made thereafter. The positive preference balance can never go below zero, however.[267] It is not possible to simply add up the total allegedly preferential payments received and then subtract the total extensions of new credit during the preference period. No courts allow such a "net result" rule.[268]

Subsequent advances of new value may be used to offset prior (although not necessarily immediately prior) preferences. A creditor is permitted to carry forward preferences until they are exhausted by subsequent advances of new value.[269] In other words, the creditor is allowed to apply new value against the immediately preceding preference as well as against all prior preferences.[270] The majority of courts hold that this rule reflects a more realistic view of commercial practices, because it accounts for the debtors' entire financial picture and repayment history and not solely on the latest payment.[271]

A new value defense is permitted "unless the debtor repays the new value by a transfer which is otherwise unavoidable."[272] This actually means that "paid" new value can still provide a subsequent advance credit against a preference (as long as it is otherwise unavoidable).[273] This is sometimes referred to as the "no double dipping" rule.

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

[267] 11 U.S.C. §47(c)(4); *In re Meridith Manor*, 902 F.2d 257 (4th Cir. 1990).

[268] The "net result rule" was the rule prior to the change from the Bankruptcy "Act" to the Bankruptcy "Code" in 1978. Bankr.Act July 1, 1898, c. 541, §60, sub. c, 30 Stat. 562, 11 U.S.C.A. §96, providing that "if a creditor has been preferred, and afterwards in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set-off against the amount which would otherwise be recoverable from him," entitles such a creditor to a deduction of the amount of the new credits from the preferences which, he is required to surrender before proving his claim, and is not limited in its application to cases where the trustee sues to recover the preferences.

Kahn v. Cone Export & Commission Co., 115 F. 290 (5th Cir. 1902). The net result rule had been judicially created based on the equity powers of the federal judiciary.

Judicially created "net result rule" for determining preferential transfer is no longer viable, in view of Bankruptcy Code's "subsequent advance rule." Bankr.Code, 11 U.S.C.A. §547(b)(5), (c)(4); *In re Fulghum Const. Corp.*, 706 F.2d 171 (6th Cir. 1983), 11 U.S.C. §547 of the Bankruptcy Reform Act of 1978. The addition of the word "after" has led to use of the modified net result rule, which has become known as the "subsequent advance rule."

[269] *Thomas W. Garland, Inc., v. Nooney Company* (*In re Thomas W. Garland, Inc.*), 28 B.R. 87 (Bankr. E.D. MO 1983)*; Mosier v. Ever-Fresh Food Co.* (*In re IRFM, Inc.*), 52 F.3d 228, 232 (9th Cir. 1995).

[270] *Meredith Manor School of Horsemanship v. Crichton* (*In re Meredith Manor*), 902 F.2d 257, 259 (4th Cir. 1990).

[271] *Meredith Manor School of Horsemanship v. Crichton* (*In re Meredith Manor*), 902 F.2d 257, 259 (4th Cir. 1990); *Mosier v. Ever-Fresh Food Co.* (*In re IRFM, Inc.*), 52 F.3d 228, 233 (9th Cir. 1995) [based upon the Garland rule "new value may be used to offset more than the immediately prior preference"]; *see also The Successor Committee of Creditor Holding Unsecured Claims v. Bergen Brunswig Drug Co.* (*In re Ladera Heights Community Hospital, Inc.*), 152 B.R. 964, 969 (Bankr. C.D. Cal. 1993) ["[t]he Garland subsequent advance rule has achieved majority status because ... the rule comports not only with the language of the statute and Congressional intent, but also serves the legislative goal of encouraging creditors to maintain business relationships with financially troubled enterprises by recognizing the commercial realities of these transactions"].

[272] *Mosier v. Ever-Fresh Food Co.* (*In re IRFM, Inc.*)*,* 52 F.3d 228, 232 (9th Cir. 1995). The 11 U.S.C. §547(c)(4) exception contains two key elements, "[f]irst, the creditor must give unsecured new value and, second, this new value must be given after [emphasis omitted] the preferential transfer." *Id.* at 231. The Court reasoned that this approach meets the policy underlying preference actions in allowing the new value exception to encourage creditors to "continue to do business with financially troubled debtors, with an eye towards avoiding bankruptcy altogether." *Id.* at 232.

[273] There is another interpretation that is used in a minority of courts that may be described as the "remains unpaid" approach. This approach would limit the offset to only the immediately preceding transfer (preference). *Leathers v. Prime Leather Finishes Co.*, 40 B.R. 248 (D.C.Me. 1984). This is also the rule used in *In re Jet Florida System, Inc.,* 841 F.2d 1082 (11th Cir. 1988); *New York City Shoes, Inc. v. Bentley Int'l, Inc.* (*In re New York City Shoes, Inc.*), 880 F.2d 679 (3d Cir. 1989); *In re Discovery Zone, Inc.,* 300 B.R. 856 (Bkrtcy. D. Del. 2003); *In re Prescott,* 805 F.2d 719, (7th Cir. 1986); *P.A. Bergner & Co. v. Bank One, Milwaukee, N.A.* (*In re P.A. Bergner & Co.*), 140 F.3d 1111, 1121 (7th Cir. 1998); *In re GGSI Liquidation, Inc.,* 313 B.R. 770 (Bkrtcy. N.D.Ill. 2004). This rule has not been adopted in most circuits. Even in the First Circuit there is a more recent opinion reflecting the majority view. *In re Jannel Industries, Inc.,* 245 B.R. 757 (Bkrtcy. D. Mass. 2000).

Most courts do not follow the "unpaid" rule and have criticized that interpretation as inconsistent with the statute. *In re IRFM, Inc.,* 52 F.3d 228 (9th Cir. 1995). The statute on its face does not include the requirement that the new value remain "unpaid." The word "unpaid" is wholly absent from the statutory text. *Chrysler Credit Corp. v. Hall*, 312 B.R. 797 (E.D. Va. 2004). *See also Van Dyck/Columbia Printing v. Katz*, 289 B.R. 304 (D.Conn. 2003); *In re Baumgold Bros., Inc., 103 B.R. 436*, (Bkrtcy. S.D. N.Y. 1989); *In re Meredith Manor, Inc.*, 902 F.2d 257, 258-259 (4th Cir. 1990); *Matter of Toyota of Jefferson, Inc*., 14 F.3d 1088 (5th Cir. 1994); *Matter of Toyota of Jefferson, Inc*., 14 F.3d 1088 (5th Cir. 1994); *In re Tower Metal Alloy Co.,*193 B.R. 273 (Bkrtcy. S.D. Ohio 1996); *Schilling v. Jackson Oil Co.* (*In re Transport Assocs., Inc.*), 171 B.R. 232, 238 (Bankr.W.D. Ky.1994); *In re Thomas W. Garland, Inc.,* 19 B.R. 920 (Bankr.E.D. Mo.1982); *Kroh Bros.*

If a creditor extends a subsequent advance of new credit after a preferential transfer and the debtor later pays for that new credit, the creditor can still claim a subsequent advance for that paid new credit as long as the paid subsequent advance could not be used as a payment in the ordinary course of business or another defense. In other words, you cannot claim a subsequent advance and claim that the payment from the debtor for that subsequent advance was a payment in the ordinary course of business.

Ordinary Course of Business

This is probably the best-known defense to a preference action—it also will not help creditors as often as they think. This defense has a *three*-part test, and the creditor must pass at least two. Most creditors will fail at least the third test. The creditor must prove:

1. the debt paid was "incurred by the debtor in the ordinary course of business;" *and*
2. the payment was made in the ordinary course of business *for this debtor and this creditor* (subjective test);

   or
3. the terms were ordinary for this industry (objective test).

First, the debt being paid must have been incurred in the ordinary course of business. This can be an issue with promissory notes or liquidation agreements. The debtor may have fallen way behind on an account, the creditor filed suit and later agreed to a promissory note. The debtor may have made regular and timely payments on that promissory note for several months, but was that debt "incurred in the ordinary course of business?"[274] Also, if the debt was not ordinary trade debt, but incurred by the debtor for some extra ordinary or personal purpose, this may also not be incurred in the ordinary course of business. This creditor may not have an ordinary course defense, no matter how quickly the invoices were paid.

If the creditor can pass this first test, the creditor must then only show *either* that the payment was consistent with the payment history between this debtor and this creditor (subjective test) *or* that the payments were ordinary for this industry (objective test).[275] In other words, the creditor-defendant can choose between the last two parts of this test.

When considering the second "subjective test," creditors often have the feeling that it was "normal" for this debtor to pay late, that there was nothing unusual about the payment received and that it was "in the ordinary course of business." Investigation will usually reveal, however, that the debtor's habits changed in the months leading up to bankruptcy. A debtor that normally paid within 30 days of invoice began paying within 60 or 90 days of invoice shortly before filing bankruptcy. Even the debtor that always paid "late" stretched from 60 days after invoice to 90 or 120 days after invoice in the year of the bankruptcy. While the creditor feels the payment was "ordinary for this debtor," it was really just "ordinary for this debtor in the last six months."

If the creditor cannot satisfy the second subjective test, the creditor must also show that the payment terms were ordinary for this industry as a whole. Creditors will rarely be able to pass this test. Even if it was ordinary for this debtor to pay invoices in the 60- to 90-day range, this will rarely be ordinary for the industry in that particular market. The creditor normally also has to find an "expert witness" to testify about this particular industry in this particular geographic area. This adds significantly to the costs and legal fees in establishing an ordinary course of business defense.

This option to choose between the subjective and objective tests does make it considerably easier and cheaper for creditor preference defendants to establish an ordinary course of business defense to a preference action. It also helps creditors with short payment histories. Often, when a debtor starts getting in trouble, their regular trade vendors will cut them off. Debtors are then forced to move to new vendors for goods. These new vendors often have only a couple of months of credit history before the debtor filed bankruptcy. This makes it difficult for the new trade vendor

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Dev. Co. v. Continental Constr. Eng'rs, Inc. (*In re Kroh Bros. Dev. Co.*), 930 F.2d 648, 653 (8th Cir. 1991); *In re IRFM, Inc.,* 52 F.3d 228 (9th Cir. 1995); *In re Amick,* 163 B.R. 589 (Bkrtcy. D. Idaho 1994); (*In re M & L Business Mach. Co., Inc.*), 160 B.R. 851, 855-56 (Bankr.D. Colo. 1993), *aff'd* 167 B.R. 219 (D.Colo. 1994).

The differences between the two approaches can be dramatic. For a good explanation of the differences, *see In re PNP Holdings Corp.*, 167 B.R. 619 (Bkrtcy. W.D. Wash. 1994).

[274] 11 U.S.C. §547(c)(2).

[275] 11 U.S.C. §547(c)(2).

to show any ordinary course of business history with this debtor (subjective test)[276] and adds considerable risk to any trade vendor taking a chance on a debtor in trouble. In this case, it can be important whether the payment was within the terms of any credit agreement.[277] Now, a trade vendor with a short subjective payment history only may need to prove that the payments were ordinary for that industry and that geographic area (objective test). It is still very risky to take a chance on debtors in trouble, however, because there is still a high risk of bad debt write off and a high risk of preference actions for payments received.

The limited information in the possession of the bankruptcy trustee will normally include the debtor's check register, the bank account statements and invoice information. The attorneys for the estate (trustee) will develop a computer printout showing the date the check cleared the bank, the invoices paid with that check and the dates of those invoices. The trustee may not pursue the case unless the invoices were at least 60 or 75 days old. The trustee may also do an analysis on the average "days outstanding" for that industry to decide which cases to pursue.

In other words, if the estate (trustee) is pursuing the case, they may know the creditor has no ordinary course of business defense. Nonetheless, the creditor-defendant should do this same analysis to confirm the absence of an ordinary course defense. Some lawyers have been known to file preference actions on *any* creditor that received a check in the 90 days prior to bankruptcy, without any investigation.

Ordinary course of business defenses can also be expensive and time consuming. The creditor-defendant can probably use their own witnesses to prove that the debt was ordinary and that the payment terms were ordinary for this debtor (subjective test). Expert witnesses are necessary, however, to prove that the terms were ordinary for this industry in this market (objective test).[278] This can be expensive.

An interesting question exists with "pay when paid" clauses in a construction contract. If there is a "pay when paid" clause in a contract, a debtor will *never* pay an invoice until it has received payment from the owner or general contractor above. That payment, however, may come 120 or 180 days after invoice. It was ordinary for this debtor and ordinary for this industry, however. There is no known case law on this subject, but it would seem to be a viable defense. By the same token, it could be argued that construction contractors never pay invoices until they themselves have been paid, whether or not there is actually a "pay when paid" clause in the contract.

The moral to this story is that creditors must keep debtors current. This becomes even more important as debtors get into trouble and close to insolvency. The creditor that forced the debtor to stay current may avoid preference problems. Credit managers have long known that they have a better chance of collecting if invoices never get over 60 days. On top of that, these credit managers may avoid preference problems.

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[276] A minority of courts have articulated a *per se* rule that a single payment to a transferee can never be subjectively ordinary between the debtor and the transferee under §547(c)(2)(B). *See e.g.*, *Miller v. Kibler* (*In re Winters*), 182 B.R. 26, 28 (Bankr.E.D. Ky.1995); *Brizendine v. Barrett Oil Distributors, Inc.* (*In re Brown Transport Truckload, Inc.*), 152 B.R. 690, 691 (Bankr.N.D. Ga.1992). This wooden rule, however, undermines the policy goal of §547(c)(2)(B), which is to leave normal business practices between the parties undisturbed. *See Bohm v. Knitting* (*In re Forman Enterprises*), 293 B.R. 848, 857 (Bankr.W.D. Pa. 2003). *In re Bridge Information Systems, Inc.*, 297 B.R. 754, 757-8 (Bankr. E.D. Mo. 2003).

Most courts addressing this issue have rejected this approach and have held instead that a transaction may be in the "ordinary course" even if it is the very first transaction between the debtor and the creditor. *Bohm v. Golden Knitting Mills, Inc.* (*In re Forman Enterprises, Inc.*), 293 B.R. 848, 857-58 (Bankr.W.D. Pa.2003); *Gosch v. Burns* (*In re Finn*), 909 F.2d 903, 907 (6th Cir.1990); *Hovis v. Stambaugh Aviation, Inc.* (*In re Air South Airlines*), 247 B.R. 165, 171-72 (Bankr.D. S.C.2000); *Tomlins v. BRW Paper Co.* (*In re Tulsa Litho Co.*), 229 B.R. 806, 808 (10th Cir. BAP 1999); *Remes v. ASC Meat Imports, Ltd. (In re Morren Meat & Poultry Co.),* 92 B.R. 737, 740 (W.D. Mich.1988); *Styler v. Landmark Petroleum* (*In re Peterson Distrib.*), 197 B.R. 919 (D. Utah 1996); *In re Morren Meat*, 92 Bankr. 737 (W.D. Mich 1988) held that pre-preference period dealings are not a requirement for finding that the preference period payments were ordinary. Also *Solow v. Ogletree, Deakins, Nash, Smoak & Stewart*, 180 Bankr. 1009, 1015 (Bankr. N.D. Ill. 1995) held that the defendant should not be "effectively ... precluded as a matter of law from establishing its Section 547(c)(2) defense because of the sparse pre-preference history."

A payment will fall under the ordinary course of business exception based on these factors (1) length of time the parties were engaged in the transaction at issue; (2) whether the amount or form of tender differed from past practices; (3) whether the debtor or creditor engaged in any unusual collection of payment activities; and (4) the circumstances under which the payment was made. *In re Hancock-Nelson Mercantile Co. Inc.,* 122 B.R. 1006 (Bankr. D. Minn. 1991).

[277] The majority position will look at other factors, including whether the payment was within the terms of any credit agreement. When there is no payment history between the debtor and the transferee, the fact that the payment in question was within the terms of an arms length agreement between the debtor and the transferee is central to the subjective analysis under §547(c)(2)(B). *In re Bridge Information Systems, Inc.*, 297 B.R. 754, 757-8 (Bankr. E.D.Mo. 2003); *citing Tomlins v. BRW Paper Co, Inc.* (*In re Tulsa Litho Co.*), 229 B.R. 806, 809 (10th Cir. BAP 1999); *Bohm v. Golden Knitting Mills, Inc.* (*In re Forman Enterprises, Inc.*), 293 B.R. 848, 857-58 (Bankr.W.D.Pa.2003).

[278] *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029 (7th Cir. 1993); *See Collier on Bankruptcy* §547.04[2][b][C][IV] (15th Edition Revised, Mathew Bender 2001).

Statutory Lien

The transfers may also prevent the imposition of a statutory lien in property of the debtor. Section 547(c)(6) of the Bankruptcy Code provides that the trustee may not avoid a transfer "that is the fixing of a statutory lien that is not avoidable under §545 of this title."[279] This certainly means that filing a mechanic's lien itself cannot be a preference.[280] The creditor might get full payment post bankruptcy petition in this manner.

The question remains whether transfers that discharged a statutory lien, precluding the imposition of a statutory lien are avoidable as a preference.[281]

It would still be a critical question whether the creditor's lien "had value at the time" the transfers were made.[282] If there were sufficient funds owed to debtor by owners or general contractors such that the creditor's lien had value at the time the transfers were made, the transfers may not be avoidable by the trustee pursuant to 11 U.S.C. §547(c)(6).

Contemporaneous Exchange for New Value

The estate (trustee) may not avoid a transfer (payment or security interest) if it was "intended by the debtor and the creditor to be a contemporaneous exchange for new value."[283]

The preference creditor-defendant must show *when* the debtor received this "new value."[284] The new value is measured as of the time the transfer took place.[285]

The preference creditor-defendant must also show that both parties *intended* that the transfers were part of a contemporaneous exchange for new value.[286] It is not clear from the statute whether the preference creditor-defendant must show that the parties "*intended* an exchange," "*intended* new value" or "*intended* that the transfers be contemporaneous." Most case law, however, is concerned whether contemporaneousness is intended.[287]

COD Sales

The most obvious example of contemporaneous exchange for new value is a COD sale. The creditor gave the debtor $100 of products and received $100 cash at the same time. This transaction cannot be a preference.

For this reason, it can be a good idea to put customers in trouble on COD. In addition to making sure they get paid for this transaction, creditors are also making sure they will not need to give the money back later as a preference.

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[279] 11 U.S.C. §547 (c)(6) (2009).

[280] If the debtor granted a consensual mortgage on debtor real estate during the preference period, the mortgage itself would be a preference that could be avoided by the trustee. The fixing of an involuntary statutory lien, however, cannot be a preference under Bankruptcy Code §547 (c)(6).

[281] *In re 360 Networks (USA), Inc.*, 327 B.R. at 189; *In re White*, 64 B.R. 843, 851 (Bankr. E.D. Tenn. 1986).

[282] *In re Cocolat, Inc.*, 176 B.R. 540, 549 (Bankr. N.D. Cal. 1995).

[283] 11 U.S.C. §547(c)(1). The trustee may not avoid under this section a transfer to the extent that such transfer was—

(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

(B) in fact a substantially contemporaneous exchange.

[284] *United Rentals, Inc. v. Angell*, 592 F.3d 525, 533 (4th Cir. N.C. 2010).

[285] *Holmes Envtl. v. Suntrust Banks* (*In re Holmes Envtl., Inc.*), 287 B.R. 363, 386 (Bankr. E.D. Va. 2002), *citing In re Grand Chevrolet, 25 F.3d at 733; In re Robinson Bros. Drilling*, 877 F.2d at 33 [noting in the context of a §547(c)(1) defense that "consequently, that the lien on the well may have had no value at the time of the adversary hearing was of no importance, so long as it had value at the time of transfer"]; *In re Jet Fla. Sys*., 861 F.2d at 1559 n.5 ["The proper inquiry under §547(c)(1) should be directed at the valuation of the transfer when made"]; *In re Cocolat*, 176 B.R. at 547.

[286] *United Rentals, Inc. v. Angell*, 592 F.3d 525, 533 (4th Cir. N.C. 2010).

[287] *Holmes Envtl. v. Suntrust Banks* (*In re Holmes Envtl., Inc.*), 287 B.R. 363, 385 (Bankr. E.D. Va. 2002) [The second element regarding intent is typically the most crucial element in a new value defense. *See e.g., In re Presidential Airways, Inc.*, 228 B.R. 594, 599 (Bankr. E.D. Va. 1999) ("The critical factor is whether the parties intended a contemporaneous exchange."). *In Lubman v. C.A. Guard Masonry Contractors, Inc.* (*In re Gem Constr. Corp.*), 2000 Bankr. LEXIS 1826, No. 98-33110, Adv. 99-3047, 2000 WL 33321298 (Bankr. E.D. Va. Jan. 5, 2000) [(unpublished), the court denied summary judgment on the new value defense in part because the parties disputed whether the transaction was contemporaneous. 2000 Bankr. LEXIS 1826 [WL] at 4.]

Release of Mechanic's Lien or Bond

The "new value" given by the creditor could be the release of a security interest. If a secured lender gives up a security interest on valuable equipment in exchange for the $100 payment, this release is new value given in a contemporaneous exchange.[288] It is still an issue, however, whether the security interest had any value. If the security interest was worthless, the payment will still be a preference. Although the debtor and creditor *intended* the transaction to be a contemporaneous exchange for new value, the transaction actually was not. There was no value in the exchange and the estate was diminished. This problem could arise if the security property had no value or had been destroyed.

Notice that this "defense" is very similar to the "above the line" argument that the creditor did not receive more than it would have in the hypothetical Chapter 7 liquidation.[289] The same facts could give the creditor both arguments, although the above the line argument is better for the creditor because the trustee has the burden of proof. In a construction-contracting context, a creditor may provide a mechanic's lien release or payment bond release in exchange for a payment. The release of a surety on a bond[290] or a release of a lien[291] can be an exchange of new value.

Again, however, the creditor must show that the security interest had value.[292] In other words, if mechanic's liens or bonds had expired before the creditor received money, then the payment is still a preference. Even if the debtor demanded a mechanic's lien release and even if both debtor and creditor thought it had value, the release was actually worthless. The creditor did not actually provide value. A similar issue can exist in states with a "defense of payment" to a mechanic's lien. In such states the mechanic's lien will only be enforceable if the owner is still holding money on the general contractor, if the general contractor is still holding money on the subcontractor, etc.

Some courts have stated that creditor must actually perfect or enforce mechanic's liens or bonds before a release has any new value.[293] As discussed below, this is bad law, because it encourages diseconomic behavior.[294] Society does not want creditors wasting legal fees and disrupting construction projects by filing mechanic's liens, just to make sure the payments they are receiving can never be recovered as preferences. Most courts seem to say that the creditor must only show that there was still time to file the mechanic's lien[295] or on the bond[296] when the payment was received and that the exchange had sufficient value that the estate was not diminished.

There are, however, other problems with a contemporaneous exchange defense for discharge of a mechanic's lien or bond. The preference creditor-defendant must still show *when* the debtor received this "new value."[297] The preference creditor-defendant must also show that both parties *intended* that the transfers were part of

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[288] The new value received by a debtor does not have to come from the creditor to whom the transfer was made but may be provided by a fully secured third party. *In re Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d 224, 231 (5th Cir. 1988). The new value can come through an indirect transfer.

[289] *See* subsections above, Mechanic's Lien Rights in Debtor Real Estate and Mechanic's Lien Rights in Non-Debtor Real Estate.

[290] *In re Gem Const. Corp. of Virginia*, 262 B.R. 638 (E.D.Va. 2000); *In re Jones Construction*, 337 B.R. 579, 583 (Bankr. E.D.Va. 2006; *In re E.R. Fegert, Inc*., 887 F.2d 955, 959 (9th Cir. 1989).

[291] *See In re Jones Construction*, 337 B.R. 579, 583 (Bankr. E.D. Va. 2006) (*quoting Prairie State Bk. v. U.S.*, 164 U.S. 227, 240, 17 S. Ct. 142 (1896)); *see also Nat'l Surety Corp. v. U.S.*, 118 F.3d 1542, 1546 (Fed. Cir. 1997); *In re White*, 64 B.R. 843, 851-852 (Bankr. D. Tenn. 1986), comparing *In re Johnson*, 25 Bankr. 889 (Bankr. E.D. Tenn. 1982) and *In re Dick Henley, Inc.*, 38 Bankr, 210, 10 Coll.Bankr. Cas.2d 806 (Bankr. M.D. La. 1984). *See also In re Anderson Plumbing*, 71 B.R. 19 (Bankr. ED Cal. 1986).

[292] *Smith v. Creative Management, Inc.* (*In re Virginia-Carolina Fin. Corp.*), 954 F.2d 193 (4th Cir. 1992).

[293] *United Rentals, Inc. v. Angell*, 592 F.3d 525, 532-33 (4th Cir. N.C. 2010) [Since the preference creditor-defendant never even attempted to make any claim on the bond, the surety never obtained any lien that it could release. Just as the surety did not have an equitable lien to release since it had not paid a claim on the bond, Since the preference creditor-defendant did not have a security interest to release because it never filed the mechanic's lien claim necessary to obtain such an interest.]; *Precision Wall, Inc. v. Crampton*, 196 B.R. 299 (E.D.NC 1996); *Ragsdale v. M & M Elec. Supply, Inc.* (*In re Control Elec., Inc.*), 66 B.R. 624 (Bankr.N.D. Ga. 1986); *Tidwell v. Bethlehem Steel Corp.* (*In re Georgia Steel, Inc.*), 56 B.R. 509, 522 (Bankr.M.D.Ga. 1985).

[294] *Ricotta v. Burns Coal & Building Supply Company*, 264 F.2d 749 (2d Cir. 1959).

[295] *In re White*, *64 B.R. 843* (E.D. Tenn. 1986); *In re JA Jones*, 361 B.R. 94 (Bankr. W.D. NC 2007); *In re Mason and Dixon Lines*, 65 B.R. 973, 978 (M.D. NC 1986).

[296] *O'Rourke v. Coral Construction, Inc.* (*In re E.R. Fegert, Inc.*), 88 B.R. 258, 260 (9th Cir. App. Panel 1988), *aff'd* 887 F.2d 955 (9th Cir. 1989); *see also National Shawmut Bk. of Boston v. New Amsterdam Cas. Co*., 411 F.2d 843, 849 (1st Cir. 1969); *First Ala. Bk. v. Hartford Acc. & Indemnity Co.*, 430 F. Supp. 907, 910 (N. Ala. 1977).

[297] *United Rentals, Inc. v. Angell*, 592 F.3d 525, 533 (4th Cir. N.C. 2010) [regardless of whether the transfers set in motion a chain of events that resulted in the Debtor's recoupment of the amounts paid, the preference creditor-defendant did not show that such new value was "'given to the debtor'… as part of a 'contemporaneous exchange'"].

a contemporaneous exchange for new value.[298] These burdens could be very difficult for a preference creditor-defendant and raise many questions.

How does a lien or bond creditor show that a contemporaneous exchange was *intended*? Construction suppliers may need to require waivers signed by both the creditor and the debtor in exchange for all payments received and make sure those waivers are clear that both parties intend the payment to be in exchange for a mechanic's lien or bond. Is this sufficient evidence of intent? How does the creditor show *when* the debtor received value for the Transfer? Can a waiver be sufficient here? An example of a payment waiver that may help solve these problems is the Supplier and Subcontractor Lien and Bond Waiver in the Appendices.

Inchoate Nature of the Mechanic's Lien

One pivotal issue is what it means for a lien to be "inchoate." Does it mean that the creditor has no lien until perfection or does it mean that the creditor has the lien from the time labor or material is supplied, later lost if not perfected and enforced? It is respectfully submitted that much of the difficulty courts have had on the "need to perfect" issue, discussed below, is confusion about the nature of an inchoate mechanic's lien. In states with an inchoate mechanic's lien, an unperfected mechanic's lien has priority over the interest of the trustee as a hypothetical judgment lien creditor.[299] An inchoate lien provides a present security interest from the time labor or material is furnished.[300]

There is no question that lien laws vary from state to state and that this may alter the result in bankruptcy preference cases. One example would be states such as Florida or California, which require a "Notice to Owner" before or soon after beginning work on a project in order to ever have a lien. If the preference creditor-defendant had failed to provide this Notice to Owner, the creditor would have no lien at receipt of a payment.

The critical difference is whether the state has inchoate liens which relate back to the time work began. A striking example of a state without inchoate liens is Maryland. Maryland formerly had an inchoate lien law until the statute was dramatically revised by the legislature. Since that time, a claimant has no lien in Maryland until the court enters a final order establishing the lien.[301] Maryland's mechanic's liens "were transformed into little more than debt claims" and now have essentially the same priority as a judgment lien.[302] A bankruptcy by a property owner would stay any attempt to establish a lien and will effectively eliminate mechanic's liens.[303]

The mechanic's lien laws of the various United States generally have a common genesis, particularly in the Mid-Atlantic region. Maryland actually passed the nation's first mechanic's lien law in 1791 "at the urging of [two Virginians] Thomas Jefferson and James Madison, to facilitate the speedy construction of the new capital city of Washington." The inchoate nature of the mechanic's lien is still a constant feature in the Mid-Atlantic region outside of Maryland, including Pennsylvania, Virginia, West Virginia and both Carolinas.

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298 *United Rentals, Inc. v. Angell*, 592 F.3d 525, 533 (4th Cir. N.C. 2010). There is only one other known lower court case that has ever discussed a need to prove intent in a contemporaneous exchange, although the word "intent" definitely does appear in 11 U.S.C. §547(c)(5). There are some cases that have noted that the creditor had provided a mechanic's lien or bond waiver, but no case has stated that evidence of a waiver was necessary to prove intent. It is not clear whether a waiver would prove intent under *United Rentals, Inc*. v. *Angell*.

299 *Frank H. Conner Co. v. Spanish Inns Charlotte, Ltd.,* 294 N.C. 661, 667, 242 S.E.2d 785, 789 (1978); *see also McCoy v. Wood,* 70 N.C. 125 (1874); *Equitable Life Assurance Soc'y*, 234 N.C. 347, 67 S.E. 2d 390 (1951).

300 *Harrison & Bates, Inc. v. Featherstone Assocs. Ltd. Pshp*., 253 Va. 364, 370, 484 S.E.2d 883 (1997) [an inchoate lien attaches when the work is done and materials furnished which may be perfected within the specified time.]; *Synchronized Constr. Servs. v. Prav Lodging, LLC,* 2014 Va. LEXIS 155, 15-16 (Va. Oct. 31, 2014); *Hadrup v. Sale*, 201 Va. 421, 424-425, 111 S.E.2d 405, 407, 76 A.L.R.2d 1159 (1959).

301 *Mervin L. Blades & Son, Inc. v. Lighthouse Sound Marina & Country Club*, 37 Md. App. 265, 269-70 (Md. Ct. Spec. App. 1977).

302 *Id.* at 266.

303 It is striking that the Maryland legislature revised its lien law because Maryland's highest court had found it unconstitutional as a taking of property without due process. *Barry Properties v. Fick Bros. Roofing C*o., 277 Md. 15, 352 A.2d 222 (Md. 1976). The *Barry* court stated that "[u]nder the terms of the Maryland statute, *a lien is created and attaches* to the property as soon as work is performed or materials are supplied ... and lasts until 'the expiration of 180 days after the work has been finished or the materials furnished, although no claim has been filed for them [with the clerk of the court].'" *Id.* at 225-226 (Citations omitted) (Emphasis added). The court also stated that "... there is a 'subsisting lien' as soon as materials are supplied or work is performed ..." and that "[w]hen timely filed, the claimed lien *additionally* becomes an encumbrance of record," *not* that the lien comes into being or attaches at the time of perfection. *Id.* at 228 (Citations omitted) (Emphasis added).

There is no question the inchoate mechanic's lien "relates back" to the time labor or material is supplied. A mechanic's lien can generally be filed post bankruptcy petition and the lien cannot be avoided by the trustee for this reason.[304] Does a mechanic's lien exist from the time labor or material is supplied, as is believed by most in the construction industry? Or is there is nothing to exchange for a payment, except unsecured contract rights, unless the mechanic's lien has been perfected?[305]

It is accurate to say that the liens are "lost" if not perfected and or enforced in a timely manner. However, the lien could not be "lost" if not already possessed. One problem is that there is very little case law on the nature of the security interest *before* perfection and enforcement of the liens. By the time a mechanic's lien case gets to a state supreme (or even the trial) court, the time to perfect has expired. The state court decides either that the claimant failed to follow the statute and is now unsecured *or* that the liens were properly perfected and enforced *and* has priority over all other security interests created after work began on the project. The scenario in a bankruptcy preference case is that the claimant never perfected *because the claimant was paid in full*.[306] State courts have not provided guidance on the workings of state mechanic's liens. This job is left to federal bankruptcy judges in preference cases.

An inchoate mechanic's lien survives a sale of the property, whether or not the lien has been filed in the land records.[307] An *unperfected* inchoate mechanic's lien also has priority over a bona fide purchaser or a judgment lien creditor and over a bankruptcy trustee perfecting after work commenced.[308]

The fact that there is construction activity on the property is the public notice that the property may be subject to unrecorded mechanic's liens. This is why property sellers and mortgagors must always sign affidavits at settlement, affirming under oath that they have not ordered labor or materials to improve the property in the 90 days prior to the settlement. The inchoate mechanic's lien, which may be filed after settlement, will be prior to the rights of the buyer or the new lender that records its mortgage after work commences, but before the mechanic's lien is perfected. The inchoate mechanic's lien will also be prior to a judgment lien creditor that perfected after work commences, but before the mechanic's lien is perfected. For all the same reasons, an inchoate mechanic's lien survives a bankruptcy and prevails over the trustee.

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[304] *Concrete Structures, Inc. v. Tidewater Crane and Rigging Co.* (*In re Concrete Structures, Inc.*), 261 B.R. 627, 640-41 (E.D.Va. 2001) ["the recording of a memorandum of lien does not violate the stay imposed by §362(a)]; *H.T. Bowling v. Bain* (*In re Bain*), 64 B.R. 581 (W.D.VA. 1986). *See also* 98 A.L.R. 32.

[305] *United Rentals, Inc. v. Angell*, 592 F.3d 525 (4th Cir. N.C. 2010) seems to say that there is no lien *until* it is perfected.

[306] *McCoy v. Wood,* 70 N.C. 125 (1874). In *McCoy*, the Supreme Court of North Carolina held that an inchoate lien had priority over a *registered* consensual security instrument, notwithstanding that the inchoate lien was *never perfected*. The intervening act of payment, during the prescribed period for perfection, alleviated the need to perfect. The inchoate lien attached and was a security interest in property with priority from the time of the first supply of labor. Consequently, under North Carolina law a payment relieves a party of the necessity of perfecting a lien that attaches upon the first supply of labor and does not eliminate the security interest held by that party at the time of payment. As hypothetical holder of a security interest, the trustee is in the same position as the holder of the consensual security interest in *McCoy*.

The North Carolina Supreme Court also stated in *Equitable Life Assurance Soc'y*, 234 N.C. 347, 67 S.E. 2d 390 (1951) that:

the relation back doctrine was not begotten by [the statutes construed in *McCoy*], and is not nurtured by its present day counterpart.

The doctrine is inherent in the very statutes which give the contractor the lien upon the property improved by his labor or materials, and allow him six months after the completion of the labor or the final furnishing of the materials in which to claim it; for it is plain that unless the contractor's lien when filed relates back to the time at which the contractor commenced the performance of the work or the furnishing of the materials, the object of the statutes can be defeated at the will of the owner of the property, by his selling or encumbering his estate. To hold that the doctrine of relation back is not inherent in these statutes would be to "keep the word of promise to our ear, and break it to our hope."

[307] *See Hadrup v. Sale*, 201 Va. 421, 424-425, 111 S.E.2d 405, 407, 76 A.L.R.2d 1159 (1959); *Rural Plumbing and Heating, Inc. v. Hope Dale Realty, Inc.*, 263 N.C. 641, 653; 140 S.E.2d 330, 339 (1965).

[308] *In re Golfview Developmental Center, Inc. v. All Tech Decorating Co.,* 309 B.R. 758, 768-69 (Bankr. N.D. Ill. 2004).

If its mechanic's lien is inchoate and has priority over the trustee's interest, the creditor has the right to perfect its mechanic's lien rights after a bankruptcy petition, without obtaining Relief from the Automatic Stay.[309] Federal courts have consistently determined that a claimant has the right post-petition to perfect a mechanic's lien in states with an inchoate lien (that relates back).[310] The creditor does not improve its position by filing a mechanic's lien, during the preference period or post petition. The creditor *always had* the secured mechanic's lien rights.[311] Filing a mechanic's lien would only provide additional notice of the security rights that the creditor already had. If the creditor's inchoate lien rights prevail over the trustee post petition, how can the trustee avoid a pre-petition payment in discharge of those rights?

Need to Actually Perfect or Enforce

For years most courts stated and most attorneys believed that if you had the ability to force a payment through mechanic's liens or payment bonds at the time you received a transfer payment and you could have forced the payment even after the bankruptcy, then you therefore cannot be forced to return this payment as a preference. The most recent and highest ranking court decision on the subject, however, states that a bond creditor must actually make a claim on a payment bond before the discharge of payment bonds in exchange for a payment prevents a trustee from recovering a payment.[312] The Fourth Circuit Court of Appeals also states in this same case that a mechanic's lien creditor must actually perfect a mechanic's lien before the discharge of that mechanic's lien in exchange for a payment can be a contemporaneous exchange defense. This "need to perfect" rule has wide ranging implications for the construction industry.

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[309] *See* 11 U.S.C. §546(b) (2009); *See also H.T. Bowling*, 64 B.R. at 582-83; This is because the creditor "acquire[d] rights in such property before the date of perfection" within the meaning of 11 U.S.C. §546(b)(1)(A).

The legislative history of 11 U.S.C. §546 clarifies the limitations upon the trustee's avoiding powers. If the creditor has the opportunity to perfect its lien against an intervening interest holder as of the date of the petition, then it may perfect its interest against the trustee. The rights granted to the creditor prevail over the trustee, because perfection relates back to a date that is before the commencement of the case. *H.T. Bowling,* 64 B.R. 581, 582-83, *citing* H. R. Rep. No. 95-595, 95th Cong., 2d Sess. 371, reprinted in 1978 U. S. Code Cong. & Ad. News 5963, 6327; S. Rep. No. 95-989, 95th Cong., 2d Sess. 86, 1978 U. S. Code Cong. & Ad. News 5785, 5872.

[310] *Concrete Structures, Inc. v. Tidewater Crane and Rigging Co.* (*In re Concrete Structures, Inc.*), 261 B.R. 627, 640-41 (E.D.Va. 2001) ["the recording of a memorandum of lien does not violate the stay imposed by §362(a)"]; *H.T. Bowling v. Bain* (*In re Bain*), 64 B.R. 581 (W.D.VA. 1986). *See also* 98 A.L.R. 32.

Schafer v. Carolina Kitchen & Bath, Inc. (In re Orndorff Constr.), 394 B.R. 372375-76 (Bankr. M.D.N.C. 2008) [Pursuant to Section 362(b)(3), a bankruptcy petition "does not operate as a stay ... of any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee's rights and powers are subject to such perfection under Section 546(b)."]; *but see In re Shearin Family Investments, LLC*, Case No. 08-07082-8-JRL (Bankr. E.D.N.C., April 17, 2009).

An action to perfect a materialman's lien is excepted from the automatic stay by Section 362(b)(3). *Richardson Builders*, 123 B.R. at 738; *Victoria Grain Co. of Minneapolis v. Janesville Elevator Construction, Inc.* (*In re Victoria Grain Co. of Minneapolis*), 45 B.R. 2, 6 (Bankr. Minn. 1984) ... But Section 546(b)(1) and (2) limit the trustee's ability to avoid liens pursuant to Sections 544 and 545. Section 546(b)(1)(B) provides that "[t]he rights and powers of a trustee under §§544, 545 and 549 of this Title are subject to any generally applicable law that provides for the maintenance or continuance of perfection of an interest in property to be effective against an entity that acquires rights in such property before the date in which action is taken to effect such maintenance and continuation." Chapter 44A of the North Carolina General Statutes is such a statute. *See Cook*, 384 B.R. at 288 (state mechanic's lien law is "generally applicable law" within the meaning of §546(b))].

Yobe Elec. Co., Inc. v. Graybar Elec. Co., Inc. (*In re Yobe Elec., Inc.*), 728 F.2d 207, 208 (3d Cir. 1984) [filing of mechanic's lien against debtor who has filed Chapter 11 petition for work performed for debtor prior to filing of petition does not violate the automatic stay provisions of 11 USCA §362].

In Arkansas, the bankruptcy court found that pursuant to the relation back provision of the mechanic's lien, a properly perfected mechanic's lien on debtors' property was entitled to relief from automatic stay in order to exercise its rights in debtors' property. *In re McCord*, 219 B.R. 251, 253-53 (E.D. Ark. 1998). In Alabama, the bankruptcy court found that a party "could maintain and perfect its mechanic's lien outside bankruptcy and without automatic stay relief." *In re Cook*, 384 B.R. 282, 288 (N.D. Ala. 2008).

[311] Inchoate mechanic's lien rights are substantively different than the remedies of garnishment or attachment. Both attachment and garnishment are remedies borne of an *in personam* claim against a person or entity. Once a claim against a person or entity is established via judgment, the creditor must execute on the judgment to establish a claim against the property of the judgment debtor. The judgment does not attach to the property until execution.

In contrast, the inchoate mechanic's lien is an *in rem* claim directly against specific property. The mechanic's lien claim typically attaches to the property from the time of the "first furnishing of labor or materials" and is not reliant on notice for attachment.

[312] *United Rentals, Inc. v. Angell*, 592 F.3d 525 (4th Cir. N.C. 2010).

The Fourth Circuit Court of Appeals simply states that a payment bond does not create an above the line trustee burden issue.[313] There is no consideration of a bond in determining whether a creditor has received more than it would have in a Chapter 7 liquidation. In addition, a bond creditor must actually make a claim on a payment bond before a preference creditor-defendant has a below the line contemporaneous exchange defense.[314] The existence of payments bonds simply is not a factor in a bankruptcy preference case, unless the preference creditor-defendant had actually made a claim on the bond. The same case states that a mechanic's lien creditor must actually perfect its mechanic's lien before the release of that mechanic's lien in exchange for a payment can be a contemporaneous exchange defense.[315]

This court expressly left open the issue whether mechanic's liens could still prevent the trustee from meeting the above the line burden under 11 U.S.C. §547(b). A mechanic's lien could be a factor in determining whether a creditor has received more than it would have in a Chapter 7 liquidation. Is an indirect transfer a consideration in this analysis or will any payment be preferential if the creditor did not have a mechanic's lien directly in property owned by the bankrupt debtor? Is it necessary to actually file the mechanic's lien on property owned by the bankrupt debtor?

Most courts have held that the creditor must only show that there was still time to file the mechanic's lien or on the bond when the payment was received[316] and prove the value of the mechanic's liens or bonds in order to show the

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[313] *United Rentals, Inc. v. Angell*, 592 F.3d 525, 531 (4th Cir. N.C. 2010).

Even assuming *arguendo* that a lien or bond creditor is an unsecured creditor at the time of a transfer, the trustee still has the burden to show that the creditor would not have been secured at the time of the hypothetical Chapter 7. The distribution under this hypothetical Chapter 7 does *not* take place at the time of the transfers. *Hall v. Chrysler Credit Corp.* (*In re JKJ Chevrolet*) 412 F.3d 545, 549 (4th Cir. 2005). The hypothetical Chapter 7 is deemed to take place on the date of the bankruptcy filing. *See Sloan v. Zions First National Bank* (*In re Castletons*), 990 F.2d 551, 554 (10th Cir. 1993) ("the petition date is the relevant date for purposes of the hypothetical creditor test under 547(b)(5)"); *See also Neuger v. United States* (*In re Tenna Corporation*), 801 F.2d 819, 822 (6th Cir. 1986) (stating that the date of the petition is the date "that a payment should be tested").

If *United Rentals* and *Precision Walls* mean that a lien or bond claimant must actually perfect in order to protect against preference claims, this "need to perfect" rule assumes that a creditor unsecured at the time of the transfer is necessarily unsecured at the time of the hypothetical Chapter 7. However, the amount a creditor would have received in a Chapter 7 proceeding cannot be determined by reference to any security interest the creditor had *at the time of the preference*. *See In re JKJ Chevrolet*, 412 F.3d at 549. A lien or bond creditor could have easily become a secured creditor between the transfer and the hypothetical Chapter 7 distribution, by perfecting or enforcing. It is still the Trustee's burden to prove that the creditor would not have been secured at the time of the hypothetical Chapter 7 distribution.

This may be another way of saying that a payment discharging lien or bond rights cannot be preferential, if the lien or bond rights could have been enforced post-bankruptcy petition, with the creditor, the debtor and all general unsecured creditors left in exactly the same financial position.

[314] *United Rentals, Inc. v. Angell*, 592 F.3d 525, 532 (4th Cir. N.C. 2010) [Since United never even attempted to make any claim on the bond here, the Surety never obtained any lien that it could release.]

[315] *United Rentals, Inc. v. Angell*, 592 F.3d 525, 533 (4th Cir. N.C. 2010) [Just as the Surety did not have an equitable lien to release since it had not paid a claim on the bond, United did not have a security interest to release because it never filed the mechanic's lien claim necessary to obtain such an interest.]

[316] *In re White*, *64 B.R. 843* (E.D. Tenn. 1986); *In re JA Jones*, 361 B.R. 94 (Bankr. W.D. NC 2007); *In re Mason and Dixon Lines*, 65 B.R. 973, 978 (M.D. NC 1986).

Prior to United Rentals, Inc. v. Angell, 592 F.3d 525 (4th Cir. N.C. 2010), *Precision Walls v. Crampton,* 196 B.R. 299 (E.D.N.C. 1996) had been cited by other courts as the only case holding that a transfer is avoidable unless the recipient had actually perfected mechanic's lien rights. *In re Lockwood Greene Eng., Inc. v. Binsky & Snyder, Inc*. (*In re J.A. Jones, Inc*.), 361 B.R. 94, 102-03 (Bankr. W.D.N.C. 2007). The primary variant of most cases is whether the transfer recipient still had time to enforce mechanic's lien or bond rights at the time of the transfer and/or whether sufficient sums were still owed to the debtor on the project at the time the preference payment was made "to permit a set-off," so that the estate was not diminished.

In *Precision Walls*, the Court stated that the subcontractor had not proven the value of its lien or that the owner owed sufficient funds on the project to satisfy the lien. *See Precision Walls,* 196 B.R. at 301-02. This may be the basis of the *Precision Walls* decision. It is also not clear whether the preference defendant's lien had expired at the time of the transfers.

A similar holding *In re Joseph M. Eaton Bldrs, Inc.* has also been cited for the proposition that a transfer is avoidable unless the recipient had actually perfected mechanic's lien. *See In re J.A. Jones, Inc.*, 361 B.R. at 100 (Bankr. W.D. NC 2007). In *Eaton Bldrs*, however, the Court found that the defendants' lien had expired well before defendants received the preferential payments. *See In re Joseph M. Eaton Bldrs, Inc.,* 84 B.R. 56, 59 (W.D. Pa. 1988). The Court held that where that the defendants did not perfect its lien *and the lien had expired at the time of the transfers*, the defendants had no new value defense.

Accordingly, there may be no other case law like *United Rentals, Inc. v. Angell*, stating that a lien or bond creditor must actually perfect or enforce lien or bond before there is a contemporaneous exchange defense, where there was time to enforce liens or bonds at the time of the transfer and the estate was augmented in an amount equal to the transfer by the discharge of liens or bonds.

estate was not diminished.[317] Whether or not the preference creditor-defendant has actually enforced a mechanic's lien[318] or bond,[319] however, should not impact the above the line trustee burden analysis or the new value defense.

"The sole purpose of filing liens is to secure payment. Surely the receipt of payment itself should not be less secure than the lien which could have secured it."[320]

"Because the creditor was paid for the work, its inchoate lien was satisfied and it had no cause to record a lien against the debtor's property."[321]

"If the debtor pays the debt during the time that the materialman could perfect and as a consequence the materialman does not proceed with the perfection of the lien, the courts have recognized that the materialman relinquished a right that constitutes 'new value.'"[322]

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[317] In *United Rentals, Inc*. v. *Angell*, the creditor had shown that the time to enforce its mechanic's liens and bonds had not expired at the time of the transfer and that the bankruptcy estate had received value for the transfer, by showing that the owners and general contractors on the projects were holding funds in amounts greater than the transfer at the time. The general contractors also paid the debtor more than the amount of the transfer after the transfer.

[318] In *Ricotta v. Burns*, the defendant *could have* filed a mechanic's lien at the time each transfer payment was made. The court said: "neither the filing nor the enforcement of such a lien would have constituted a preference. Moreover, *had the liens been filed*, payment merely discharging them, without improving the creditor's position as against the general creditors of the bankrupt, would likewise have been immune from attack. *It would be absurd to treat differently payments for the same debts obtained without filing liens, and the law does not do so.* Consistent with common sense the courts have upheld payments where at the time the payments were made the creditor could have equally protected himself by filing a nonpreferential lien."

"The sole purpose of filing these liens is to secure payment. *Surely receipt of payment itself should not be less secure than the lien which could have secured it.* Moreover, the essence of a preference is that it depletes the bankrupt's estate available to remaining creditors. *Where the payment merely avoids the bite of a lien which the trustee could not have successfully attacked, no such depletion occurs."*

Ricotta v. Burns, 264 F.2d 749, 750 (2d Cir. 1959 (emphasis added) (internal citations omitted).

In a later case, the Second Circuit cited *Ricotta* and stated "where a material man could have filed liens for building materials furnished the bankrupt and the filing or enforcement of the lien would not have constituted a preference, the court would treat payments for the debts *as if liens had been filed*." *Miller v. Wells Fargo Bank International Corp*., 540 F.2d at 565 (emphasis added).

The Ninth Circuit has held that a transfer made "in discharge of a California inchoate mechanic's lien may not be avoided by the Trustee as a preference..." The court determined that the preference defendant held an inchoate lien at the time of the transfer, the "filing of which was not required by statute until some time [after the transfer]. Since the time for perfecting defendant's lien had not expired, the defendant accepted the payment "in satisfaction" of inchoate mechanic's lien right and payments were therefore not avoidable as a preference. *Greenblatt v. Utley,* 240 F.2d 243, 244-247 (9th Cir. 1956).

[319] The fact that a creditor did not actually send or enforce a bond claim does not impact the creditor's status at the time of the transfers or the fact that the estate was not diminished. When a debtor contractor breaches its contract, it precludes debtor's entitlement to retained funds, and thus these funds are not property of the estate. *In re Jones Constr. & Renovation, Inc.*, 337 B.R. at 585, (*citing First Indem. of Am. Ins. Co. v. Modular Structures* (*In re Modular Structures*), 27 F.3d 72 (3d Cir. N.J. 1994)); (*In re Pacific Marine Dredging and Constr.*), 79 B.R. 924, 929 (Bankr. D. Ore. 1987). The court is less concerned with whether payment has yet been made by a surety than with the obligation to pay claimants. The surety's obligation, brought about by the debtor's breach of contract, makes the doctrine of equitable subrogation applicable. In other words, if the debtor had not paid the creditor the transfers, the property of the estate and value of assets available to general unsecured creditors would automatically be reduced by the same dollar amount*. Id.* "A hypothetical liquidation (assuming the payment was not made) would not have provided any greater estate for distribution to unsecured creditors." *Field v. Insituform East, Inc.* (*In re Abatement Environmental. Resources, Inc.*), 307 B.R. 491, 499 (Bankr. D. Md. 2004).

"[T]he fact that the surety did not actually make the payments to the subcontractors [does not] require the application of a different equitable rule." *In re E.R. Fegert, Inc.,* 88 B.R.at 260 (BAP 9th Cir. 1988), *aff'd* 887 F.2d 955 (9th Cir. 1989). Since the transfers "avoided the imposition of an equitable lien by the surety on future payments under the contract, there was no diminution of the estate." *Id.* The surety's equitable lien "prevails over the trustee even though the surety has not perfected its rights under the Uniform Commercial Code ("U.C.C.")..." *In re E.R. Fegert, Inc.,* 88 B.R.at 260 (BAP 9th Cir. 1988), *aff'd* 887 F.2d 955 (9th Cir. 1989)*; see also National Shawmut Bk. of Boston v. New Amsterdam Cas. Co.,* 411 F.2d 843, 849 (1st Cir. 1969); *First Ala. Bk. v. Hartford Acc. & Indem. Co.*, 430 F. Supp. 907, 910 (N.D. Ala. 1977).

The transfers "are in the nature of a trust to reimburse the surety who is forced to pay on its bond." (*In re Pacific Marine Dredging and Constr*.), 79 B.R. 924, 928 (Bankr. D. Ore. 1987). The surety's equitable lien is "superior to all other liens." The "surety has no filing obligations. The lien is one created by equity, not by statute." The estate was not diminished by the transfers, because the discharge of the surety's equitable lien provided the debtor money from the general contractors equal to the amount of the transfer.

[320] *Ricotta v. Burns Coal & Bldg Supply Co.,* 264 F.2d 749, 750 (2d. Cir. 1959).

[321] *Schnittjer v. Pippert* (*In re Carney*), 396 B.R. 22, 26 (Bankr. N.D. Iowa 2008), *citing In re Golfview Developmental Center, Inc. v. All Tech Decorating Co.,* 309 B.R. 758, 769-70 (Bankr. N.D. Ill. 2004); *In re R.M. Taylor, Inc*., 257 B.R. 289, 295 (Bankr. W.D. Mo. 2000).

[322] *In re Mason and Dixon Lines, Inc.,* 65 B.R. at 979; *see also In re J.A. Jones, Inc.*, 361 B.R. at 103-04.

Since the time for perfecting the lien had not expired prior to the receipt of payments, the defendant accepted the payment in satisfaction of its inchoate mechanic's lien.[323] There is no need for a preference defendant to prove actual perfection of a mechanic's lien, if there was still time to perfect on receipt of the transfer and there was no diminution of the estate.

A few courts have placed the burden on the creditor to prove that it *would have* timely filed against the project's payment bond had it not received payment from the debtor.[324] This is unusual, however, at odds with case law from most other courts, and at odds with logic and public policy considerations. Any such rule would be very problematic.[325]

There is no need for the creditor to prove what it would have done absent payment. There is no doubt that a mechanic's lien or bond claimant must perfect, enforce *and* successfully prosecute it's case to judgment before the ability to force payment from either mechanic's liens or payment bonds is finally established. However, the intervening payment made it *impossible* to perfect, enforce or successfully prosecute an action to judgment.

The creditor no longer *has* a mechanic's lien or bond after payment. We will never see perfection or enforcement after payment. An *unpaid* supplier would have the right to force payment from either mechanic's liens or bonds post-petition. It would be an illogical result, if the only defendant shielded from a preference attack is the defendant that had actually perfected prior to payment. Any creditor paid during the preference period without perfection must give that money back as a preference, while any creditor unpaid during the preference period still has the ability to force payment from a mechanic's lien or bond post-petition. An unpaid supplier is better off than a paid supplier, if the debtor files bankruptcy.

Another problem with the "need to perfect" rule is that it does not tell us how far we need to go. Would it not also be necessary to actually enforce with a lawsuit in state court prior to payment? How do we know that the mechanic's lien creditor would have enforced its mechanic's lien with a lawsuit? Does the mechanic's lien creditor need to prove it would have properly enforced, in the correct court, with all necessary parties and allegations? Does the mechanic's lien creditor need to prove it would have hired competent counsel?

Experience and logic tell us that it will be unusual facts that a preference defendant has perfected prior to payment. The preference period is relatively brief, the 90 days prior to bankruptcy, while a mechanic's lien usually need not be perfected until 90 days after the last work on the project. By definition, the debtor is continuing to make payments during this time. Even fewer creditors will have filed suit on their mechanic's lien or bonds within the preference period. A mechanic's lien typically must be enforced within six to twelve months of last work. A trial determining that the claimant has *properly* perfected and enforced *and* establishing the precise dollar amount due to claimant, will not occur until at least a year after last work.

It should also be noted that in the case of a mortgage lender or any other secured creditor, any trustee could make the same argument that the secured creditor must prove that it would have properly enforced its security to obtain payment. However, there is no known case of any trustee trying to make this argument. The payment automatically

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[323] *Greenblatt v. Utley,* 240 F.2d 243, 247 (9th Cir. 1956); *see also In re 360 Networks (USA), Inc.,* 327 B.R.187 (Bankr. S.D.N.Y. 2005) (identifying *Precision Walls* as "the one case under the Code that holds that an unperfected statutory lien should be treated no differently from any other unperfected lien"); *See also Mullins v. Noland Co.,* 406 F. Supp. 206 (N.D. Ga. 1975); *See also In re Electron Corp.,* 336 B.R. 809 (BAP 10th Cir. 2006); *See also Schnittjer v. Pippert* (*In re Carney*), 396 B.R. 22 (Bankr. N.D. Iowa 2008); *See also In re Golfview Developmental Center, Inc.,* 309 B.R. at 758; *See Simon v. Engineered Protection Sys., Inc.* (*In re Hartfield Elec. Co.*)*,* 91 B.R. 782, 786 (Bankr. N.D. Ohio 1988); *LaRose v. Crosby & Son Towing, Inc.* (*In re Dick Henley, Inc.*), 38 B.R. 210, 214 (Bankr. M.D. La. 1984).

[324] *Angell v. Pennington et al*. (*In re Partitions Plus of Wilmington, Inc.*), 2008 Bankr. LEXIS 1994 at *8-9 (Bankr. E.D. N.C. 2008).

[325] The Bankruptcy Court for the Western District of North Carolina dealt with this in an illuminating public policy analysis:

> Since an individual subcontractor's reaction is unknowable, an objective approach should be employed, asking "what would a reasonable materialman have done in response to that nonpayment." It takes little commercial construction expertise to answer. A reasonable subcontractor would assert his legal rights, liening the project, perfecting those liens and forcing payment through the owner.
>
> We should also assume a reasonable behavior by the project owner. Again, this requires almost no imagination. With liens on this project, the owner would have no reasonable alternative but to pay the subcontractor and then seek indemnification from the general contractor.
>
> To make any other assumption would defy reality. It would also penalize the lien creditor for accepting payments. (*citing Ricotta*, 264 F.2d at 750 "The sole purpose of filing liens is to secure payment. Surely, the receipt of payment itself should not be less secure than the lien which could have secured it.") It would also defy commercial reality. A subcontractor would not long remain in business if it made a practice of refusing payments from its general contractor in favor of enforcing lien rights against the underlying project. No one would hire such a subcontractor.

In re JA Jones, 361 B.R. 94, 103 (Bankr. W.D. NC 2007).

discharges the security. "[E]very payment made by the debtor increases the debtor's equity in the collateral, thereby proportionally enhancing the value of the bankruptcy estate."[326]

We can never know whether claims would have been properly perfected or enforced, because that payment intervened. Payment must alleviate the need to perfect or enforce or to prove that either would have been done properly. Asking a defendant to prove what would have happened without payment is an impossible burden. In any event this burden would be with the trustee, as either mechanic's lien or bonds would establish the defendant as a secured creditor.

The correct question must be whether the defendant *could* have forced payment through mechanic's liens or bonds at the time of payment, which would have resulted in the same payments despite the bankruptcy, all without diminishing the bankruptcy estate for the benefit of general unsecured creditors.

If a preference defendant has to show that it did or that it would have perfected or enforced, the public policy ramifications are enormous.

First, any construction supplier or subcontractor would need to refuse payment and instead file mechanic's lien or on bonds as an ordinary practice (as soon as the debtor was one day beyond its ordinary terms) to avoid bankruptcy preference claims, even if there is no reason to suspect an imminent bankruptcy.

The only safe path would be to actually file mechanic's lien or on bonds in all cases, to be released on receipt of payment. This would disrupt projects and business relations, generate legal fees and consume court resources toward no end. In some cases, it may be possible to reach agreement with an owner, general contractor and debtor that liens will be filed and immediately released. This has obvious problems, but is the only risk free alternative. There will be cases with enough money involved that creditors must proactively take this action. This may be profitable for mechanic's lien and payment bond lawyers, whose services will be necessary at every monthly construction progress draw.

It will help if the debtor acknowledges a bond claim and/or mechanic's lien at the time of payment and agrees that mechanic's liens or bonds are released in exchange for this payment. This could be done in the form a of a progress payment waiver, similar to waivers used now, but both the creditor receiving payment and the debtor must sign.[327] This is obviously a better alternative to actually perfecting mechanic's liens and/or against payment bonds before accepting payment. An example is the Supplier and Subcontractor Lien and Bond Waiver in the Appendices.

All construction suppliers or subcontractors will also want to enforce mechanic's liens and bonds immediately on any bankruptcy for money *it has been paid* in the 90 days prior to the petition. This would certainly disrupt projects and business relations, and make any orderly bankruptcy reorganization impossible. It is, of course, very questionable whether a supplier or subcontractor *can* file a mechanic's lien or on the bond for money it has been paid. At a minimum the creditor would have to swear a false affidavit that it was owed the sum paid.[328] An unpaid supplier would be better off than a paid supplier on bankruptcy.

If creditors have received large payments on mechanic's lien or bond projects from a debtor that files bankruptcy, they should request a bankruptcy court order shortening the time for the debtor to bring a preference action. This allows the creditor to bring the bonding company, the property owner and general contractors into the preference lawsuit, before the deadlines to enforce liens and bonds expire and while they still have records or witnesses readily available. A debtor that really wanted to avoid paying a certain lien or bond creditor could accomplish that end by *actually paying* the creditor right before bankruptcy. "The Debtor/Contractor could, in effect, avoid payment of any or all subcontractors by paying them within 90 days of bankruptcy and then simply waiting until 60 days after substantial completion of the work before filing the action to recover the preference. By doing so, the subcontractor could effectively be denied its lien rights."[329]

It is not uncommon that a construction contractor suffers financial difficulties that threaten to stall work on construction projects because of nonpayment to subcontractors and suppliers. To limit this risk of nonpayment and the resulting consequences of delayed and higher cost construction projects, state legislatures passed mechanic's lien statutes to provide security to construction contractors on private construction projects. Similarly, the federal government recognized the importance of assuring payment to construction contractors on public construction

[326] *Small v. Williams*, 313 F.2d 39, 44 (4th Cir. 1963).

[327] However if the debtor is not the bond principal, then it may also be necessary to get the bond principal to also "acknowledge" the bond claim.

[328] *In re Golfview Developmental Center, Inc.,* 309 B.R. at 768.

[329] *In re Dick Henley, Inc.,* 38 B.R. at 215.

projects and passed the Miller Act, requiring payment bonds for the protection of construction contractors. The legislatures of every state in the country followed suit with a so-called "Little Miller Act" for the same purpose on state projects. All of these statutes recognize the economic importance of protecting construction contractors and facilitating lower priced construction projects through limitations on risks.

The result of a "need to perfect" rule is that, in the event of bankruptcy, a construction contractor is only protected from the risk of nonpayment if that contractor does not receive payment. An unpaid contractor is protected by these remedial mechanisms and can collect payment for its work, despite the bankruptcy. In contrast, a contractor who has been paid is prevented from pursuing these remedies and is then forced to return the payments to the debtor at a time beyond the deadlines to preserve any remedy. The paid contractor retroactively becomes unprotected. This is exactly what the state legislatures and the federal government have sought to prevent through legislation. How can an unpaid supplier be better off than a paid supplier after a bankruptcy petition?

Courts often speak of the purpose of the contemporaneous exchange defense, to accommodate the need of financially unsteady companies to use checks to pay for new transactions."[330] However, it would seem that a "need to perfect" rule would actually hasten the demise of financially unsteady construction companies. Creditors now need to file mechanic's liens and on any bonds before accepting any payment to be certain of protection from future preference claims. This will disrupt construction projects and business relations, cause unsteady subcontractors to lose jobs and increase legal fees for businesses, without any identifiable public policy advantage. Rather than preventing the race to the courthouse, the "need to perfect" rule has made it mandatory.

If a construction material supplier could successfully obtain payment after a bankruptcy petition, then receipt of the same payment pre-petition cannot be an avoidable preference, as long as the bankruptcy estate was not diminished. A paid construction material supplier cannot be worse off under the Bankruptcy Code than an unpaid supplier. The proper standard is whether the creditor received more than it would have in a Chapter 7 and did not diminish the estate, not proof that the creditor actually did perfect or actually would have perfected to force payment under with a mechanic's lien or bond in the absence of the payments. This is a sufficient standard to protect the general unsecured creditors in a bankruptcy.

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[330] *United Rentals, Inc. v. Angell*, 592 F.3d 525, 534-35 (4th Cir. N.C. 2010).