

**WHAT TO DO WHEN A PARTY ON A
CONSTRUCTION PROJECT GOES BANKRUPT**

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TABLE OF CONTENTS

- I. INTRODUCTION 1**
- II. SCOPE OF DISCUSSION 1**
- III. THE BASICS 2**
- IV. WHAT YOU CAN DO TO BECOME INFORMED 2**
 - A. Notice of Appearance 2**
 - B. Meeting of Creditors 3**
 - C. SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT? 3**
- V. PROOF OF CLAIM 4**
 - A. The Need to File a Claim 4**
 - B. The Time for Filing 4**
 - C. Filing a Claim is Consent to Jurisdiction 5**
 - D. SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT? 6**
- VI. THE AUTOMATIC STAY 6**
 - A. The Bankruptcy Code Provisions 6**
 - B. When Does the Stay Apply? 7**
 - C. To What Acts Does the Stay Apply? 7**
 - D. Violations of the Stay 8**
 - E. The Co-Debtor Stay 8**
 - F. Motion Practice and Local Rules 9**
 - G. SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT? 9**
- VII. DEALING WITH THE CONSTRUCTION CONTRACT 10**
 - A. Exercise of Contract Rights Might Violate the Stay 10**
 - B. The Executory Contract 10**
 - C. The Terminated Contract 11**
 - D. Assumption of the Contract 11**
 - E. SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT? 11**
- VIII. CONTRACT PROCEEDS – ARE THEY OR AREN’T THEY PROPERTY OF THE ESTATE? 12**
 - A. Property of the Estate 12**
 - B. Trust Funds 12**
 - C. Joint Checks 13**

D.	Favorable Contract Terms and Set-Off	13
E.	Recoupment	14
F.	Options for Owners or General Contractors	14
G.	SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT?	15
IX.	MECHANIC’S LIEN - PERFECTION AND ENFORCEMENT	16
A.	How it Appears	16
B.	Relation Back and Perfection	16
C.	Enforcement of Liens is Stayed	16
D.	SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT?	17
X.	SURETY’S RIGHTS AND OBLIGATIONS	17
A.	Bankruptcy and Bonds	17
B.	The Equitable Lien	18
C.	Priority to Retainage and Perhaps Progress Payments	18
D.	Surety’s Options	18
E.	SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT?	19
XI.	NONDISCHARGEABILITY UNDER SECTION 523	19
A.	No Discharge for Corporations	19
B.	Fraud Claims	19
C.	Chapter 13 Discharges Fraud	20
D.	The Trust Fund and Fiduciary Capacity	20
E.	Fraud in the Pay Applications of Subs and Vendors	20
F.	Evaluate the Cost Effectiveness	20
G.	SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT?	21
XII.	<u>CONCLUSION</u>	21

WHAT TO DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT

I. INTRODUCTION

The construction industry is known for its volatility. It is sensitive to even slight changes in the local and national economy. Even in times of economic stability construction contract defaults occur with some degree of frequency. Such defaults become far more frequent when a project is impacted by a weak local or national economy.

The typical construction project begins with a contractual relationship between a general contractor and the owner. Soon, numerous other parties are involved, with the owner making arrangements with one or more lenders, and the general contractor having one or more tiers of subcontractors, sub-subcontractors and respective suppliers under it. The claims or defaults of any one of these entities will present unique problems for the others, especially in the bankruptcy context. This is true because such claims or defaults typically implicate the rights and obligations of the other parties in the construction contract chain.

The financial interests of the contractors (at all tiers) and the suppliers are sometimes protected by state law, surety bonds and/or non-bankruptcy federal law. The non-bankruptcy rights and entitlements often are interpreted, litigated, and adjudicated in the bankruptcy case, thereby adding to the complexities that arise when a party in the construction contract chain files bankruptcy. A lawyer acting for one of the parties in the construction contract chain must know what to do when a party on a construction contract goes bankrupt.

II. SCOPE OF DISCUSSION

Many substantive areas of bankruptcy law come into play when a party on a construction contract files bankruptcy. In any given bankruptcy case the rights of a party in the construction contract chain likely will be determined or at least affected by one or more areas of substantive bankruptcy law, or the interplay among multiple substantive areas of bankruptcy law. Most of these substantive areas of law are of sufficient depth and complexity to warrant law review articles and seminar topics dedicated exclusively to them. Consequently, this presentation does not include a comprehensive analysis of the many substantive areas of bankruptcy law affecting the rights of a party on a construction project. Some discussion of these substantive bankruptcy topics is necessary, however, to provide guidance in representing the interests of a party on a construction project when the bankruptcy of another party on the project can adversely impact the interests of others.

This presentation reviews various procedural and substantive rights of non-debtors when a party on a construction project files bankruptcy, and what a party or its counsel can do, or indeed, must do in order to preserve and best protect its rights and interests in connection with that

bankruptcy. The author, in preparing this discussion, assumes the reader has little or no bankruptcy practice experience but, if the need were to arise, could find his way to the local bankruptcy court.

III.

THE BASICS

The current bankruptcy law under which we operate is generally known as the “Bankruptcy Code” and is found at Title 11 of the United States Code. There are also Federal Rules of Bankruptcy Procedure governing the exercise of bankruptcy rights and fulfillment of certain obligations. Those rules are found in Title 28 of the United States Code.

There are several different chapters in the Bankruptcy Code, providing different or alternative relief for prospective debtors. This presentation considers primarily bankruptcy filings under Chapter 7, 11 and 13. *See* 11 U.S.C. § 701, *et seq.*, § 1101, *et seq.*, and §1301, *et seq.* (2000). For the most part, the bankruptcy rules and other sections of the Bankruptcy Code that will be discussed in this presentation apply equally in Chapters 7, 11 and 13, unless noted otherwise.

Every bankruptcy case is initiated by the filing of a petition. *See* 11 U.S.C. §§ 301, 303 (2000). Under the old bankruptcy act there was an event known as “adjudication of bankruptcy” which meant that, at that point, the person or entity was determined to be bankrupt, typically by court order. The concept of “adjudication of bankruptcy” was not brought forward into the Bankruptcy Code. Rather, we have an “order for relief” which has the same effect of declaring that the person or entity is entitled to the protections of the Bankruptcy Code. In a voluntary bankruptcy case the mere filing of a bankruptcy petition constitutes the “order for relief.” *See* 11 U.S.C. § 301 (2000).

Although there are several different and alternative bankruptcy chapters available to prospective debtors, bankruptcy law requires that every bankruptcy case under every Chapter must have a Meeting of Creditors. *See* 11 U.S.C. § 341(a) (2000). Upon the filing of a bankruptcy petition, the bankruptcy clerk’s office prepares and distributes to all listed creditors and parties in interest a notice entitled “Notice of Commencement of Case.” That notice sets forth the date, time and location for the scheduled Meeting of Creditors. All creditors and parties in interest in the case are entitled to attend the meeting, observe the bankruptcy Trustee (or representative of the United States Trustee’s office, where appropriate) examine the debtor or representative of the debtor, under oath, and ask their own questions of the debtor.

IV.

WHAT YOU CAN DO TO BECOME INFORMED

A. Notice of Appearance

If a client has an interest in a bankruptcy proceeding, either as a creditor or a party in interest, the lawyer often can remain apprised of the status of the proceeding by having his name and address added to the service list. You may be added to the service list by filing a pleading asking that your name be added to the service list and serving the pleading on everybody involved in the bankruptcy. Different attorneys use different forms of notice, but most have the same effect. Attached as Appendix “A” is one of the simplified forms the author uses, entitled “Notice of Appearance and Request for Notices.” Once the notice is filed and properly served, you should be able to stay generally updated concerning the status of the case as a result of the mailings and notices you receive.

The filing of the Notice of Appearance and Request for Notices serves two purposes. First, it is generally the case that a creditor or party in interest is listed on the bankruptcy schedules by a debtor, but the creditor’s or party in interest’s attorney is not. By filing the Notice of Appearance and Request for Notices you, as counsel, will be entitled to directly receive copies of pleadings and notices issued in the bankruptcy. Second, and at least as important, the bankruptcy rules do not require service of all papers, pleadings and filings on all creditors and parties in interest. While certainly some pleadings and notices are required to be served on all creditors and parties in interest, others are only required to be served on a few particularly situated creditors or groups of creditors. By filing a Notice of Appearance and Request for Notices you then become entitled to service of all papers, pleadings and notices filed in the case.

B. Meeting of Creditors

Attendance at the Meeting of Creditors conducted in each case is another way to become informed about matters affecting your client’s interests. If your client has any financial stake whatsoever in a pending bankruptcy, you should take advantage of the Meeting of Creditors to obtain “free discovery.” The discovery will not be in depth or exhaustive, but it may provide an opportunity to ask questions of the debtor and debtor’s counsel and, to the extent that there is a Trustee involved, to educate the Trustee in connection with concerns or special interests your client may have. For example, if your client has an executory contract with the debtor, you can utilize the Meeting of Creditors to inquire of the debtor, while its representative is under oath, whether it intends to assume or reject the contract. Moreover, there likely will be other creditors in attendance with questions that may result in some useful information benefitting your client.

An attorney can best represent the interests of his client who is a creditor or party in interest in the bankruptcy proceeding when the attorney is aware of the debtor’s actions and of activities that may positively or adversely impact the property or interests of the debtor, in the bankruptcy proceeding. Counsel can maximize the information available for review and consideration by attending the Meeting of Creditors and filing a Notice of Appearance and Request for Notices, and counsel should do so in each bankruptcy case in which he is involved.

C. *SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT?*

- *When you learn of the bankruptcy filing, promptly obtain information such as the case number, date of Meeting of Creditors and other useful information.*
- *File and serve your Notice of Appearance, but recognize that it likely will not be processed in time for you to be on the mailing list to receive the Notice of Commencement of the Case, which contains the information on the scheduling of the Meeting of Creditors.*
- *Attend the Meeting of Creditors, with your client’s representative if at all possible.*
- *Review the pleadings and notices you receive to see how the relief sought will affect your client.*

V.
PROOF OF CLAIM

A. The Need to File a Claim

A proof of claim can, in some respects, be analogized to a creditor’s ticket for admission to the bankruptcy proceeding. The general rule is no ticket, no admission, and no late admission will be allowed. That is, with very narrow exception, if the client fails to timely file its Proof of Claim, you and your client, as an unsecured creditor will probably lack standing to participate in the bankruptcy proceeding and in a distribution after the bar date. Proofs of claim are also important for secured creditors except that a creditor with collateral securing its claim will continue having the benefit of that collateral or secured claim even if it fails to timely file a Proof of Claim. *See In re Friesenhahn*, 169 B.R. 615, 631-32 (Bankr. W.D. Tex. 1994).

Exceptions to the need to timely file Proofs of Claim do exist and they include:

- (a) Chapter 11 cases where the claim has been accurately scheduled by the debtor and is not listed as unliquidated or disputed, and neither the Disclosure Statement nor Plan, nor other order from the court provide independently for a claims bar deadline;
- (b) Circumstances where a party seeks and receives leave to file a late claim;
or
- (c) Circumstances where the time for filing your claim is “enlarged” as the result of a motion you have filed.

B. The Time for Filing

In cases under Chapter 7 and 13, claims must be filed not later than ninety (90) days after the date first set for the first Meeting of Creditors. *See Fed. R. Bankr. P. 3002(c)*. A Proof of

Claim for a claim resulting from payment of an avoidance action judgment or claim (such as preference or fraudulent transfer) must be filed within thirty (30) days after the judgment or determination of the claim. *See* Fed. R. Bankr. P. 3002(c)(3).

The timely filing of a Proof of Claim is essential because under the Bankruptcy Code a late filed claim is subordinated entirely to timely filed claims, and receives a distribution only after all timely filed claims are paid in full. *See, e.g.* 11 U.S.C. § 726(a) and § 502(b)(a) (2000); *In re Wilson*, 96 B.R. 257, 262 (9th Cir. 1988). Full payment of all claims is rare in bankruptcy; consequently, clients with late-filed claims are less likely to have a recovery.

A Motion to Enlarge Time for Filing a Claim may be granted if the creditor can establish “excusable neglect,” but that standard is difficult to satisfy and is defined differently by the different circuits. *Compare* *Midwest Employers Casualty Co. v. Williams*, 161 F.3d 877, 884 (5th Cir. 1998), *with* *Latham v. Lopez*, *available at* LEXIS 6199 (W.D. Tex. 1993). It is helpful to have a working history with both debtor’s counsel and the bankruptcy Trustee if you are seeking enlargement of time, for you may be able to procure either an agreement with your motion or an agreement they will not oppose your motion. If you are successful in obtaining an enlargement of time, your claim will be treated the same as other creditors in your class.

Claims for administrative expenses, which often arise from the provision of post-petition goods or services to the debtor, must be presented to the Court by way of an Application for Approval of Administrative Claim rather than just by mere filing of a Proof of Claim. *See In re Horne*, *available at* LEXIS 1520 (Bankr. N.D. Tex 1993).

C. Filing a Claim is Consent to Jurisdiction

So, should you, as counsel for a creditor in a bankruptcy proceeding, rush to file your Proof of Claim as early as possible to ensure you do not miss the bar date? Not until you have thoroughly analyzed your client’s position in the bankruptcy and the likelihood that it will be made a party to a preference action, collection action filed by the debtor or other proceeding in the bankruptcy court. If there is a likelihood your client will be a preference or fraudulent transfer defendant, a party in an action removed from state court to bankruptcy court or otherwise named a defendant in an adversary proceeding in the bankruptcy, you need to evaluate the availability and desirability of removing the case from the bankruptcy court and having it tried to a jury in the federal district court. The filing of a Proof of Claim constitutes a consent to jurisdiction of the bankruptcy court and eliminates the prospect of removing the case to federal district court by what is known as a “Withdrawal of the Reference.” *See In re Fang Operators, Inc.*, 158 B.R. 643, 645-646 (Bankr. N.D. Tex. 1993). So, what do you do if you are approaching your claims bar deadline and you know that at least a prospect exists that your client will be a party to a proceeding in which it does not wish to consent to bankruptcy court jurisdiction? A dilemma is created when facing a claims bar deadline without being willing to consent to bankruptcy court jurisdiction. While the Ninth Circuit has held that where a creditor has acted diligently and aggressively opposed bankruptcy court jurisdiction, the mandatory filing of its claim by the bar deadline does not constitute consent to jurisdiction, there is not similar authority from the other

circuits. *Compare* In re Castlerock Properties, 781 F.2d 159 (9th Cir. 1986), *with* In re SG Phillips Constructors, Inc., 45 F.3d 702 (2nd Cir. 1995)(rejecting argument that filing Proof of Claim under protest in order to avoid losing rights does not constitute consent to jurisdiction).

Unfortunately, there is no simple solution to the dilemma created by the potential loss of a claim by failing to meet a claims bar deadline and the consent to bankruptcy court jurisdiction that arises by operation of law when a claim is filed. Counsel is best advised to review the facts and circumstances with an experienced bankruptcy practitioner in hopes of finding an acceptable solution. Attached hereto as Appendix “B” is a photocopy of the official form generally utilized in filing a Proof of Claim in Chapter 7 and 11 cases. Chapter 13 Proofs of Claim are somewhat different, being printed for the specific, scheduled creditor. The Appendix “B” form will suffice in preserving a claim in a Chapter 13 proceeding.

D. *SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT?*

- *Investigate the claims bar deadline, if there is one, from the Notice of Commencement of Case or from the bankruptcy clerk’s docket sheet.*
 - *NOTE – the deadline for filing a proof of claim is generally 90 days from the date first set for the first meeting of creditors – not the date of the actual meeting of creditors. It is not uncommon for the meeting date to be reset, but the 90 days continues to run from the date first set for the Meeting of Creditors.*
- *In Chapter 11 cases, investigate whether there is a claims bar deadline – there may not be. If not, review the schedules to see if your client is scheduled in the proper amount with its claim not shown to be disputed or unliquidated. If the claim is properly scheduled and not shown to be disputed or unliquidated and no claims bar deadline has been established there is no need to file a Proof of Claim.*
- *Evaluate, or obtain assistance evaluating whether your client will be prejudiced by consenting to bankruptcy court jurisdiction by filing a Proof of Claim, and whether that prejudice outweighs the potential loss of a claim by failing to timely file one.*
- *If you must file a Proof of Claim then do so timely.*

VI.
THE AUTOMATIC STAY

A. The Bankruptcy Code Provisions

Most of us are aware that the filing of a petition in bankruptcy operates as a stay of the commencement or continuation, including the issuance or use of process, in a judicial, administrative, or other action or proceeding against the debtor that was or could have been

commenced before the commencement of the bankruptcy case, or to recover a claim against the debtor that arose before the commencement of the bankruptcy case. *See* 11 U.S.C. § 362(a)(1). (2000). The automatic stay also prohibits acts exercising control or the continued exercise of control over property of the estate. *See Id.* at (a)(3). This particular prohibition would include the exercise of control over a contractor's tools or materials that a general contractor or owner would otherwise, under the terms of some construction contracts, be entitled to possess or control. Moreover, the automatic stay of Section 362 also has been interpreted to restrict or prohibit certain acts involving a debtor that arose exclusively post-petition; that is, after the filing of the bankruptcy. *See, e.g.,* In re Bottone, 226 B.R. 290 (Bankr. D. Mass. 1998).

B. When Does the Stay Apply?

Logically, the first step in analyzing the implications of the automatic stay as it may pertain to your client's rights is to determine whether the stay even applies. It most assuredly applies when a claimant pursues action against the debtor or the debtor's property, or property of the estate. *See* In re Criswell, *available at* LEXIS 12784 (5th Cir. 1997); In re Continental Air Lines, 61 B.R. 758 (Bankr. S.D. Tex. 1986). In this respect, both the Bankruptcy Code and case law provide a broad scope of definition of what constitutes property of the estate. Generally, property of the estate includes all legal or equitable interests of the debtor in the property as of the commencement of the case, along with certain interests in property that the estate acquires after the commencement of the case, as well as interests in property that the debtor in possession or Trustee is entitled to recover under certain "avoidance" provisions of the Bankruptcy Code. *See* 11 U.S.C. § 541(a)(1), (3) and (7) (2000). The automatic stay also has been found to apply even to actions against a third party non-debtor entity if the action would adversely affect property of the estate. *See* Middleton & Dugger Plumbing & Heating, Inc. v. Richardson Builders, Inc., 123 B.R. 736, 740-741 (Bankr. W.D. Va. 1990). Additionally, as a practical matter the automatic stay applies when the bankruptcy court says it applies. Bankruptcy judges have broad equitable powers under Section 105 of the Bankruptcy Code and have been known to exercise the equitable powers to stay acts against debtors when such acts can reasonably be expected to negatively impact either the debtor or property of the estate. An example of the bankruptcy court's exercise of this equitable power to extend the automatic stay to non-debtors is found in the *Johns-Manville* bankruptcy case. *See* 33 B.R. 254, 263-64 (Bankr. S.D.N.Y. 1983). The bankruptcy judge extended the automatic stay to cover the corporate debtor's officers and directors who were being diverted from performing their business functions by attendance at depositions conducted in the thousands of asbestosis lawsuits that caused the bankruptcy filing. The court reasoned that the corporate debtor would have little hope for an effective reorganization if its officers and directors were prevented from tending to business of the company because their time was otherwise entirely consumed by the litigation. *See id.*

C. To What Acts Does the Stay Apply?

It is also helpful to consider to what acts the automatic stay does or does not apply. As noted above, it applies to acts against the debtor or property of the estate. Despite the broad definition of property of the estate set forth in the Bankruptcy Code and case law, there are certain

circumstances in which construction contract proceeds under a contract with the debtor may not be considered property of the estate. *See* *Cutler-Hammer, Inc. v. Wayne*, 101 F.2d 823, 825 (5th Cir.) *cert. denied*, 307 U.S. 635 (1939). In that event, if the property is not property of the estate, then the automatic stay will not likely protect it. A cautious claimant will begin with the premise, however, that any property associated with a debtor or its contracts will be considered to be property of the estate. For example, a contract to which a debtor is a party is considered to be property of the estate, and the automatic stay will apply to keep an owner from terminating a debtor's contract. *See* *Nissan Motor Acceptance Corporation v. Baker*, 239 B.R. 484, 489-90 (Bankr. N.D. Tex. 1999). The automatic stay will apply to keep an owner or general contractor from taking possession of a contractor's tools or materials even though the construction contract authorizes it under certain circumstances. Additionally, while the Bankruptcy Code recognizes a creditor's right to set off claims the creditor owes to the debtor against claims owed by the debtor to the creditor in most cases, the provisions of Section 362 prohibit exercise of the set off without first obtaining bankruptcy court approval. *See* 11 U.S.C. § 362(a)(7) (2000); *See* *Exxon v. Compton Corp.* 22 B.R. 276, 277-78 (Bankr. N.D. Tex. 1982).

D. Violations of the Stay

Violations of the automatic stay occur from time to time as the result of confusion, misinformation or ignorance. From a practical perspective it is important to recognize that most bankruptcy judges jealously guard and protect their jurisdiction and authority, and view with extreme displeasure what they perceive to be disregard for their jurisdiction and authority. In that respect, if any question whatsoever exists concerning whether the stay applies to your situation you will be well served to defer to bankruptcy court jurisdiction. In the case of a violation of the automatic stay resulting from a mistake, Texas case law provides that the offending act is void. *See* *Howell v. Thompson*, 839 S.W.2d 92 (Tex. 1992). However, Fifth Circuit case law suggests that the act is merely voidable. *See* *Sikes v. Global Marine, Inc.*, 881 F.2d 176 (1989). Actual damages, attorney's fees and even punitive damages may be assessed for willful violations of the automatic stay. *See* 11 U.S.C. § 362(h) (2000).

E. The Co-Debtor Stay

In addition to the automatic stay of 11 U.S.C. Section 362, Chapter 13 of the Bankruptcy Code creates a co-debtor stay that operates to the benefit of persons or entities obligated along with a Chapter 13 debtor on a certain debt or obligation. *See* 11 U.S.C. § 1301 (2000). It is wise to be aware of the existence of this co-debtor stay, but from a practical standpoint it likely will have little implication in a construction project context because the provision stays acts involving attempts to collect a consumer debt. *See* 11 U.S.C. § 1301(a) (2000). The Bankruptcy Code defines "consumer debt" as a debt incurred by an individual primarily for a personal, family, or household purpose. *See* 11 U.S.C. § 101(8) (2000). The prospect of confronting a co-debtor stay issue in a construction project context is further minimized because Chapter 13 is available only to individuals and not corporate entities. *See* 11 U.S.C. § 109(e) (2000). Chapter 13 is titled **ADJUSTMENT OF DEBTS OF AN INDIVIDUAL WITH REGULAR INCOME**. *See* 11 U.S.C. Chapter 13 (2000). Consequently, in order for the co-debtor stay to become an issue for

your client in a construction context the debtor would have to be an individual and the debt owing to your client would have to be one incurred primarily for a personal, family, or household purposes. It is not likely that both of these criteria would often be satisfied in the construction project context.

F. Motion Practice and Local Rules

The preparation and filing of a Motion for Relief from Stay seem to attract more participation by non-bankruptcy lawyers than any other bankruptcy activity. However, it is also one of the most highly structured and regulated procedures, by local rule. For example, any attorney wishing to file a Motion for Relief from Stay in the Southern District of Texas Bankruptcy Court should be familiar with and assure complete compliance with Local Rule 4001. Attached as Appendix “C” is a copy of Local Rule 4001. The rule requires completion of a specific form of cover sheet which is available from the clerk’s office. A copy of the cover sheet form is attached as Appendix “D”. Failure to utilize the cover form will result in the motion being declined by the clerk’s office. Failure to comply with other requirements of the local rule may result, depending upon the judge, in dismissal of the motion or refusal to grant the relief requested, even if the debtor fails to respond. Proof of the required service is essential before the court will grant the relief requested and, on default orders (where the debtor fails to respond) a certification by counsel for the Movant that Movant has complied with the requirements of local rule 4001 is required by most judges. In cases where there is a Trustee – and Trustees are notorious for not responding to Motions for Relief from Stay – it is helpful for counsel to be able to represent to the court that the Trustee was consulted and has no objection to the motion or does not take a position, one way or another, concerning the motion. A recitation to that effect in the default order is helpful.

Finally, keep in mind that a hearing on a contested Motion for Relief from Stay is really a trial, requiring exhibit lists, exhibits and evidence. Though the hearing will be set by the clerk’s office for a specific date and time, when a large docket of Motions for Relief from Stay will be set, actual dates and times for the evidentiary hearing will be determined by the court’s schedule. The Movant must be prepared, however, to proceed on the date and time specified in the notice.

G. *SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT?*

- *Analyze or obtain help analyzing whether the automatic stay applies to acts taken or to be taken by your client, or if an exception applies.*
- *If the debtor is downstream the construction chain from your client, or if you are representing a surety not in the chain, and your client wants to interfere with the normal flow of construction contract funds to the debtor/contractor, evaluate if the funds are property of the estate.*

- *Determine if there may be a co-debtor stay in existence.*
- *Be mindful that your client cannot terminate a debtor's construction contract (even if the debtor is the owner) without obtaining relief from the stay, unless you are confident you can convince the court that there is absolutely no value in the contract for the debtor and therefore it is not property of the estate. You might be well served by filing a Motion to Compel the Debtor to Assume or Reject the Executory Contract, for as will be seen in the next section the debtor must cure defaults as a condition to assumption. If it elects to reject the contract, then your client has no need to terminate the contract.*
- *Evaluate your client's lien rights. If they relate back to a pre-petition event or time, continue perfecting the lien, whether the debtor is the owner or a contractor.*
- *If you already have a lien perfected, or you continue with lien perfection, and the debtor is not the owner you can proceed to seek to enforce your lien rights, but you cannot join the debtor in the action. If the owner is the debtor, you must obtain relief from the stay before seeking foreclosure. (See Section IX, below).*
- *Check the local rule procedures for filing and prosecuting Motions for Relief from Stay.*

VII.

DEALING WITH THE CONSTRUCTION CONTRACT

A. Exercise of Contract Rights Might Violate the Stay

As mentioned in the preceding discussion of the automatic stay, the exercise of certain contract rights may be prohibited by the automatic stay if they are deemed to constitute acts against the debtor, debtor's property or estate, or to have an adverse effect on the estate. By way of example, actions to terminate a debtor's construction contract are prohibited. *See In re Glover Construction Co.*, 30 B.R. 873, 882 n.25 (Bankr. W.D. Ky. 1983). Similarly, acts such as taking possession of a debtor/contractor's tools and materials, although perhaps authorized under the construction contract, would be a violation of the automatic stay. If the tools and materials had been seized prior to the bankruptcy filing then the party possessing those items will be considered to be a "custodian" under Section 543 of the Bankruptcy Code and can be compelled by the debtor-in-possession or Trustee to preserve, safeguard and turn over those items for the benefit of the debtor and/or estate. *See* 11 U.S.C. § 543(a) and (b)(1) (2000); *See* *Browning v. Navarro*, 826 F.2d 335, 340 (5th Cir. 1987).

B. The Executory Contract

In most cases the construction contract will be an executory contract, as contemplated by Section 365 of the Bankruptcy Code. An executory contract is one under which the obligations of both the debtor and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach of the contract. *See Vern Countryman, Executory Contracts in Bankruptcy*, 58 Minn L. Rev. 439, 479 (1974). If the contract is an executory contract, the Bankruptcy Code gives the debtor or Trustee the right to assume or reject it. In a Chapter 7 case the Trustee must make the election to assume or reject within sixty (60) days after the filing of the bankruptcy, otherwise the contract is deemed rejected. However, the time period for assuming or rejecting a construction contract in a Chapter 11 case extends until the Chapter 11 Plan is confirmed. *See generally United Parcel Services, Inc. v. Weben Industries, Inc.*, 794 F.2d 1005, 1006 (5th Cir. 1986).

C. The Terminated Contract

If the contract was actually terminated pre-petition, then it is not an executory contract. *See Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1212 (7th Cir.) *cert. denied*, 469 U.S. 982 (1984). However, if the contract provides that after issuance of the notice of termination the contractor has a certain period of time within which to cure defaults in order to prevent termination, then if the contractor files bankruptcy during that cure period the contract is not deemed to be terminated pre-petition and is an executory contract under bankruptcy law. *See Deborah S. Griffin, Post-Termination Bankruptcy Considerations for the Defaulted Contractor*, 17-Jan. Construction Law 2 (1997).

D. Assumption of the Contract

In order to assume a contract the debtor or Trustee must cure or provide adequate assurance that they will promptly cure existing defaults and provide adequate assurance of future performance under the contract. *See* 11 U.S.C. § 365 (b)(1)(A) and (C) (2000). In some instances a surety may be able to block assumption of a construction contract by arguing that the bonds required under the contract are not assumable under Section 365(c)(2). This provision of the Bankruptcy Code prevents a debtor or Trustee from assuming an executory contract if it is a contract to make a loan or extend other debt financing or financial accommodations to or for the benefit of the debtor, or to issue a security of the debtor. *See* 11 U.S.C. § 365(c)(2) (2000).

As noted above, in a Chapter 11 case the debtor has until the time of confirmation of the Plan to assume or reject the contract. If your client is a party to an executory contract and does not know whether the Chapter 11 debtor intends to assume or reject, your client may not be able to wait indefinitely for the debtor to make the election. You can ask the court, by filing a motion, to compel the debtor to make the election to assume or reject the executory contract. *See Phoenix Exploration, Inc. v. Yaquinto*, 15 F.3d 60, 62 (5th Cir. 1994). Not only will this assist your client in learning whether it needs to seek a replacement contractor or subcontractors, but in the event the debtor wishes to assume the contract, this procedure should expedite the curing of defaults under the contract.

E. SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT?

- *Evaluate whether your client's contract with the debtor is a valid and enforceable contract as of the date of the bankruptcy filing. If the contract was terminated pre-petition it is extinguished. Bankruptcy does not resurrect a previously-terminated contract. If the contract was not terminated pre-petition your client cannot terminate without obtaining relief from the automatic stay.*
- *If your client wants to terminate the contract, you can file a Motion for Relief from Stay. If your client does not mind living with the contract if the debtor cures existing defaults, investigate whether the trustee/debtor will assume or reject the contract.*
- *Be aware that Chapter 11 debtors do not have to decide whether to assume or reject a contract until confirmation of the Chapter 11 Plan. You should consider filing a Motion to Compel the Debtor to Assume or Reject an Executory Contract in Chapter 11 cases.*

VIII.

**CONTRACT PROCEEDS – ARE THEY OR
AREN'T THEY PROPERTY OF THE ESTATE?**

A. Property of the Estate

The term “property of the estate” has a broad definition under bankruptcy law. However, despite the broad definition a debtor must have either a legal or equitable interest in the property for it to be property of the estate. *See Safeway Managing Gen. Agency v. Osherow*, 253 F.3d 807, 809-10 (5th Cir. 2001). If it is property of the estate, it is subject to the control and custody of the debtor or trustee. Whether the debtor has an interest in contract proceeds under a construction contract is often determined by state statute, the construction contract terms, perhaps terms of an agreement with a surety, or a combination of all three.

There are three common arguments made in asserting certain construction proceeds are not property of the estate. First, a claimant may contend it is a beneficiary of a statutory or express trust. The statutory trust obviously would be a creation of the legislature, while an express trust may be created by the construction contract or terms of a surety bond. Second, the claimant may contend the debtor's interest is nothing more than a conduit for payment. Third, the claimant may contend the funds held by the owner are subject to equitable or constructive trusts for the benefit of subcontractors or suppliers. *See Vulcan Materials Co. v. Jack Raus, Inc.*, 157 B.R. 592, 597 (Bankr. W.D. Tex. 1993).

B. Trust Funds

If the contract proceeds are trust funds, then, at best, a debtor will have bare legal title to such funds, thereby making them property of the estate, but only as to such legal title. *See e.g., Georgia Pacific Corp. v. Sigma Service Corp.*, 712 F.2d 962, 964 (5th Cir. 1983). The characterization of contract proceeds as trust funds can result from the existence of a statutory trust, constructive trust or equitable trust. This characterization of the proceeds as trust funds is most important for downstream subcontractors or suppliers who have no remaining lien rights. *See Universal Bonding Ins. Co. v. Gittens and Sprinkle Enterprises*, 960 F.2d 366 (3rd Cir. 1992).

As noted above, if the funds are trust funds, then the debtor may have legal title to the funds and under Section 541 of the Bankruptcy Code a party holding such funds may have to turn them over to the Trustee or to the estate. *See Stewart v. Law Offices of Dennis Olson*, 93 B.R. 91, 92 (Bankr. N.D. Tex. 1988). It is important to note, however, that the estate has no greater rights to the funds than the debtor would have outside bankruptcy. *See United Parcel Service*, 794 F.2d at 1008 (1986). Similarly, a secured lender with a security interest in contract proceeds in certain circumstances would have a claim inferior to that of a subcontractor with a lien claim, particularly in a case where the construction contract provides that the debtor/contractor is not entitled to payment of contract proceeds until all lien claims and other unpaid claimants under it have been satisfied in full. *See id.* A surety that has paid out amounts to satisfy claims of subcontractors and vendors will have priority over a secured lender under the theory of subrogation. *See United States Fidelity and Guaranty Co. v. First State Bank of Salina*, 494 P.2d 1149 (Kan. 1972).

C. Joint Checks

In some circumstances payment may be made by joint check to a debtor/contractor and a subcontractor or vendor, in which event a determination must be made whether the payment is property of the estate of the debtor/contractor. That determination depends upon the parties' intention as to whether the debtor is merely a conduit for payment. *See Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1356 (5th Cir.) *reh'g denied* 801 F.2d 398 (1986) (*en banc*). Presumably, the debtor at most may have bare legal title to the funds. That may be enough to support a turnover claim by the debtor/contractor, but if the other party to the joint check owns the equitable interest it is likely to ultimately prevail in recovering the proceeds.

D. Favorable Contract Terms and Set-Off

It is important for one holding contract proceeds (such as an owner or general contractor) to avoid liability for double payment. Protection may be found in seeking relief from the stay to set off amounts owing to the debtor/contractor against amounts the debtor/contractor owes the owner or general contractor, under terms of the contract. Routinely the terms of the contract obligate the debtor/contractor to pay or bond around outstanding liens and claims of unpaid subcontractors and vendors. Appendix "E" is an excerpt of such language as discussed by the Fifth Circuit in *United Parcel Service*. 794 F.2d at 1008 (1986). The party holding the proceeds should file a Motion for Relief from Stay seeking authority to make the payments directly to the claimants under the contract and to set off those amounts against contract proceeds otherwise

owing by the owner or general contractor to the debtor/contractor. The Bankruptcy Code requires Motions for Relief from Stay to be heard not later than thirty (30) days after they are filed, so this is an expeditious manner of getting before the court and possibly obtaining prompt approval for direct payments around the debtor/contractor. *See* 11 U.S.C. § 362(e) (2000). While a contractor or owner could file an adversary proceeding seeking a declaratory judgment that the remaining contract proceeds are not property of the debtor or of the estate, an adversary proceeding is a full lawsuit within the bankruptcy case and typically takes several months to reach trial and a final disposition. Consequently, it is not an efficient or expeditious means of obtaining the desired relief.

While the Bankruptcy Code recognizes the right of a creditor to set off a claim, a party must first obtain relief from the automatic stay to do so. *See* *In re Appel*, 166 B.R. 624 (Bankr. S.D. Tex. 1994). Set off requires a “mutuality” of the debt, in that both obligations in question must have arisen pre-petition. *See* *In re Hill*, 19 B.R. 375 (Bankr. N.D. Tex. 1982). The two claims, however, need not have arisen from the same transaction or series of transactions. *See id.* In the event the funds or proceeds in question are not property of the estate, as may be the case where the debtor/contractor is obligated to pay all claims and expenses before being entitled to the contract proceeds, relief from the stay may not be necessary. It is possible a bankruptcy court could find that the debtor/contractor has at least legal title to the funds, in which event relief from the stay to conduct a set-off would be necessary. In that case, the debtor/contractor’s failure to pay the claims and expenses as required under the terms of the contract creates a claim by the owner against the debtor, but certain courts have held the claim is created only as to underlying claims the owner or general contractor was obligated to pay, such as lien claims or completion costs. *See* *In re Flanagan Bros. Inc.*, 47 B.R. 299 (Bankr. D.N.J. 1985); *In re Scherer Hardware & Supply, Inc.*, 9 B.R. 125 (Bankr. N.D. Ill. 1981) (set-off not allowed where suppliers paid had not perfected liens and court therefore considered payments voluntary.)

E. Recoupment

The theory of recoupment also may be available in dealing with contract proceeds. Recoupment requires that both the claims by and against the debtor have arisen out of the same transaction. *See* *In re Clowards Inc.*, 42 B.R. 627, 628 (Bankr. D. Idaho 1984). The automatic stay does not bar recoupment. *See* *In re Visiting Nurse Association of Tampa Bay, Inc.*, 121 B.R. 114 (Bankr. M.D. Fla. 1990). Several courts have held that recoupment, as distinguished from the right of set off, may be exercised by a creditor to withhold payments due the estate without regard to the requirements applying to set-offs, including the requirements imposed by Section 362 (the automatic stay provision) of the Bankruptcy Code. *See, e.g.*, *Holford v. Powers*, 896 F.2d 176, 179 (5th Cir. 1990); *See also* *Rooster v. Raphael Roy, S.R.L.*, 127 B.R. 560, 570 (Bankr. E.D. Pa. 1991) (automatic stay does not prohibit creditor from exercising a right to recoupment). Recoupment is generally asserted as a defense to efforts by a debtor to gain possession of funds.

F. Options for Owners or General Contractors

In many instances an owner or general contractor will initially hold contract proceeds when advised that a contractor has filed bankruptcy, and decline to disburse the proceeds to the debtor/contractor. The debtor/contractor then may file an action seeking turnover of the proceeds as property of the estate. Certain defenses are available to the owner or general contractor holding the proceeds in response to the turnover claims. They can argue that no account receivable is owing to the debtor because the contract terms agreed by the debtor have not been met. *See United Parcel Service*, 794 F.2d at 1007 (1986). They can possibly pay the subcontractor or vendor directly, even if there is no right to set-off, or no lien claim may still be available, if the contract clearly provides the debtor/contractor is not entitled to the proceeds until all subcontractors and suppliers have been paid. Appendix “F” is an example of some contract terms helping establish that a debtor/contractor with unpaid claimants is not entitled to contract proceeds. Finally, of course, the argument can be made that the debtor/contractor has no interest in the proceeds or, at best, a bare legal title interest in the proceeds because they are trust funds under various, accepted legal theories. *Id.* at 1009. Certainly, the safest course of action for a party holding proceeds is to file a Motion for Relief from Stay seeking express authority to distribute those proceeds to downstream subcontractors and vendors. However, even absent express authority various defenses exist for the owner or general contractor who bypasses the debtor/contractor and pays subcontractors and vendors directly.

G. SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT?

- *Evaluate whether the proceeds are property of the estate.*
 - *Are they trust funds?*
 - *Did the debtor violate terms of the contract such that it is not entitled to the proceeds?*

- *If an argument can be made that the proceeds are not property of the estate, a conservative approach is to seek relief from the automatic stay*
 - *By an owner or upstream contractor, seeking authorization to set off funds and pay claimants directly.*
 - *By a surety, to demand the owner or general contractor pay funds to the surety based on its rights of subrogation, indemnification or exoneration.**This approach is best and safest, as it will bring all those with claims to the funds, even lenders secured by accounts receivable and contract proceeds, before the court.*

- *A less conservative approach is to pay by joint check, with the understanding (preferably in writing) that the debtor/contractor is a mere “conduit” for payment.*

- *The least conservative approach is to pay the claimants directly without prior authorization, and prepare to raise various defenses (perhaps successfully so) when the debtor or trustee files a turnover proceeding.*

- *Seek an agreement with the debtor/trustee to pay the claimants, and have the agreement approved by the court.*
- *Do not pay the funds to the debtor/trustee without first fully investigating the existence and amounts of unpaid claims and your client's right to pay the claimants.*

IX.
MECHANIC’S LIEN - PERFECTION AND ENFORCEMENT

A. How it Appears

At first glance it would seem that the prohibitions of the automatic stay of Section 362 would preclude perfection of a mechanic’s lien against property of a debtor/owner after the filing of a bankruptcy petition. After all, Section 362(a)(4) prohibits “any act to create, perfect or enforce any lien against property of the estate.” However, Section 362(b) provides the filing of a bankruptcy petition does not operate as a stay.

(3) under subsection (a) of this section, of any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the Trustee’s rights and powers are subject to such perfection under section 546(b) of this title or to the extent that such act is accomplished within the period provided under section 547(e)(2)(A) of this title. . .

11 U.S.C. § 362(b)(3) (2000). Section 546(b) as referenced in 362(b)(3) relates to limitations on the avoiding powers of Trustees and provides that such avoiding powers of the Trustee are subject to generally applicable law that “permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection.” *See* 11 U.S.C. § 546(b)(1)(A) (2000).

B. Relation Back and Perfection

In states such as Texas where the statutory scheme provides for relation back of a mechanic’s lien to the inception of the work, the requirements of Section 546(b)(1)(A) are met. That is, a mechanic’s lien claimant could have a lien against the subject property effective against a party purchasing the subject property, even before the lien is perfected, as a consequence of the relation back theory. Consequently, Section 362 does not prohibit perfection of a mechanic’s lien claim relating back to a time pre-petition, in a relation back jurisdiction. *See generally* In re Nash Phillips/Copus, Inc., 78 B.R. 798 (Bankr. W.D. Tex 1987). However, in a jurisdiction where the mechanic’s lien is not deemed to relate back it is doubtful that the provisions of 546(b) would be satisfied and therefore perfection of the mechanic’s lien most likely would violate the automatic stay.

C. Enforcement of Liens is Stayed

It is important to note that the exception from the automatic stay applies only to perfection of a mechanic’s lien and not to enforcement. There is no exception built into the automatic stay statute authorizing post-petition enforcement of a mechanic’s lien similar to the exception authorizing post-petition perfection of the lien. This prohibition against lien enforcement certainly can create a dilemma for a mechanic’s lien claimant approaching a deadline to commence an enforcement action in order to avoid losing the claim to the statute of limitations. This could

appear to create a serious problem in a jurisdiction such as California that requires commencement of the lien enforcement proceeding within ninety (90) days after filing of the lien, as opposed to a state like Texas with a more liberal statute of limitations of not less than two (2) years from the date of the filing of the lien. *Compare* Cal. Civ. Code § 3144 (Deering 1986 & Supp. 1999), *with* Tex. Prop. Code § 53.158(Vernon Pocket Supp. 2002). The Bankruptcy Code, however, recognizes that the imposition of the automatic stay could result in lost claims due to the expiration of statutes of limitation during the pendency of the stay, and has addressed the problem by providing in Section 108(c) that as a matter of law the period for filing actions will be extended for thirty (30) days after termination or expiration of the stay. *See* 11 U.S.C. § 108(c)(2) (2000). Of course, you can also file a Motion for Relief from Stay seeking authority to commence the lien foreclosure proceeding to prevent loss of the claim to limitations, but the likelihood of such relief being granted in a Chapter 11 Reorganization proceeding may not be great. However, the court may order adequate protection payments or other form of relief.

D. *SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT?*

- *Evaluate your client's lien rights.*
- *Perfect the lien rights if they relate back to a pre-petition event or time, whether the debtor is the owner or contractor.*
- *If the debtor is not the owner, you may proceed to enforce the lien.*
- *If the debtor is the owner, seek relief from the automatic stay or request for adequate protection in connection with your lien rights in seeking authority to enforce the lien.*
- *Remain vigilant as to when the automatic stay terminates in that bankruptcy case, for you will have only a 30-day window to file your enforcement action if the 2-year statute of limitations has otherwise expired.*

X.

SURETY'S RIGHTS AND OBLIGATIONS

A. Bankruptcy and Bonds

As one can imagine, the filing of bankruptcy of a Contractor with a payment bond puts the surety in a very difficult position. Subcontractors and vendors will waste little time in asserting their payment bond claims, and the owner of the project likely will withhold contract proceeds out of fear of being liable to pay the same funds twice if it pays the wrong party the first time. Moreover, in a Chapter 11 proceeding the debtor/contractor will be desperate for any cash it can get its hands on and will therefore do all it can to compel the owner to make payment to it rather than to a surety.

B. The Equitable Lien

Courts have determined that where a surety has paid out money under a bond to satisfy liens and claims the surety is either a legal or equitable owner of the contract funds or has an equitable lien. *See Pacific Indemn. Co. v. Grand Ave. State Bank of Dallas*, 223 F.2d 513, 520 (5th Cir. 1955). This status results from the surety's rights of subrogation, indemnification and exoneration. *See id.* Courts have held that these rights relate back to the time of issuance of the bond, which is typically pre-petition. *See Prairie State National Bank v. United States*, 164 U.S. 227, 239-40 (1896).

C. Priority to Retainage and Perhaps Progress Payments

There is some agreement among the courts that the surety should have a priority claim to retainage, superior to the claim of the debtor, at least to the extent of the funds the surety has paid on claims under its bond. *See Fidelity & Deposit Co. of Md. v. Scott Bros. Const. Co.*, 461 F.2d 640 (5th Cir. 1972). The courts are not as consistent in holding the surety should have priority as to progress payments. This can create a delicate situation for a surety who is obligated under its bond with the owner to satisfy unpaid subcontractors and vendors while the surety does not even have the benefit of the automatic stay that its principal enjoys.

D. Surety's Options

Counsel for a surety whose principal has just filed bankruptcy would be well-advised to promptly evaluate the debtor/contractor's ability and propensity to pay its subcontractors and vendors. If the surety has been paying claims arising under the debtor/contractor prior to the bankruptcy filing, or if it is clear the surety will be obligated to pay claims after the bankruptcy filing, counsel should be prepared to act promptly to seek bankruptcy court approval of assertion of its subrogation, indemnification and/or exoneration rights. It may occur that the surety, the project owner and the debtor/contractor reach an agreement concerning future funding for completion of the project and payment of claims. Even in that event, however, it is likely that bankruptcy court approval of the agreement will be necessary because (1) it most likely will deal with authorizing payment of unsecured creditors prior to confirmation of a Chapter 11 plan; (2) it probably will deal with a disposition of "property of the estate" (contract proceeds); and (3) it likely will provide assurance of some sort of priority claim for the surety in exchange for payments it may make. In the event the parties cannot agree, however, then perhaps the quickest way the surety can obtain a ruling on its claim to contract proceeds would be filing a Motion for Relief from Stay seeking authority to demand the owner pay the contract proceeds directly to the surety rather than to the debtor/contractor. A Motion for Relief from Stay must be determined within thirty (30) days after its filing or the relief requested will be deemed granted by operation of law. It is even possible the motion could be set for an earlier hearing if an emergency motion seeking expedited consideration were filed along with the motion.

E. SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT?

- *Evaluate the debtor's ability to pay ongoing claims and expenses.*
- *If the surety has paid claims, speak with the owner or upstream contractor about payments being made direct to the surety and not to the debtor/contractor. However, at this point do not demand such payments.*
- *If you receive no satisfaction in having the funds paid direct to the surety, file a Motion for Relief from Stay seeking authority to demand that the owner satisfy the surety's subrogation claim.*

XI.

NONDISCHARGEABILITY UNDER SECTION 523

A. No Discharge for Corporations

Section 523 of the Bankruptcy Code addresses claims that are not discharged in bankruptcy. As a preliminary matter, it is important to note that corporations do not receive discharges under the Bankruptcy Code. For that reason there is absolutely no benefit to filing a Complaint to Determine Exception to Discharge (also known as Complaint to Determine Dischargeability of Debt) in a case involving a corporate debtor.

B. Fraud Claims

Most people are aware of the general concept that a claim based upon fraud committed by a debtor is nondischargeable in bankruptcy. Section 523(a)(2) is perhaps the most well known exception to discharge subsection. That subsection provides that a discharge under the Bankruptcy Code does not discharge an individual debtor from any debt

for money, property, services or any extension, renewal, or refinancing of credit, to the extent obtained by –

- (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;
- (B) use of statement in writing –
 - (i) that is materially false;
 - (ii) respecting the debtor's or an insider's financial condition;
 - (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
 - (iv) that the debtor caused to be made or published with an intent to deceive. . .

11 U.S.C. § 523(a)(2)(A) and (B) (2000).

C. Chapter 13 Discharges Fraud

Despite the rather clear pronouncement that claims resulting from the fraud of a debtor are nondischargeable, such claims **ARE DISCHARGEABLE UNDER CHAPTER 13**. While the lengthy laundry list of nondischargeable claims in Section 523 applies to Chapter 7 and Chapter 11 cases, Chapter 13 contains its own built in limitation concerning which elements of Section 523 apply in a Chapter 13 case. *See* 11 U.S.C. § 1328(a)(2) (2000). The exception to discharge for fraud has not been incorporated into Chapter 13. *See generally* AT&T Universal Card Services v. Mercer, 246 F.3d 391, 404 (5th Cir. 2001). As addressed elsewhere, however, Chapter 13 is available only to individuals and not corporations, and therefore will perhaps be encountered less frequently in the construction project context than Chapter 7 and Chapter 11 cases.

D. The Trust Fund and Fiduciary Capacity

Subsection (a)(4) of Section 523 of the Bankruptcy Code excepts or excludes from discharge those claims based upon fraud or defalcation by the debtor while acting in a fiduciary capacity. *See* 11 U.S.C. § 523(a)(4) (2000). The fiduciary capacity frequently exists as a result of trusts, with the Trustee owing the fiduciary responsibility to the beneficiaries. The trust fund statutes create trusts from which fiduciary responsibilities arise, and a violation of the fiduciary responsibilities can give rise to a claim for exception to discharge. *See* In re Nicholas, 956 F.2d 110, 112-14 (5th Cir. 1992) (construing the Texas trust fund statute as creating fiduciary duties encompassed within Section 523(a)(4) to the extent it defines wrongful conduct). It is important, however, to bear in mind that more than a “mere” breach of fiduciary duty is necessary to support a finding of nondischargeability. Rather, there must be proof of fraud or defalcation while acting in the fiduciary capacity. *See* Gains v. Thomas, 235 B.R. 864, 865 (Bankr. N.D. Tex. 1999). Moreover, case law is uniform in holding that a fiduciary relationship must predate the wrongful act. *See* Whalen v. Carter, 954 F.2d 1087, 1092 (5th Cir. 1992).

E. Fraud in the Pay Applications of Subs and Vendors

Claims of fraud and misrepresentation by the debtor/contractor regarding payment to subcontractors and suppliers (such as in pay applications, lien waivers, etc.) have formed the basis of nondischargeability actions against debtors. *See* B & G Crane Serv., Inc. v. Dolphin Titan Int’l, Inc. 762 F.2d 1292 (5th Cir. La. 1985). To the extent a creditor, such as an owner, paid money to a debtor/contractor in reliance upon a false representation that all subcontractors and suppliers had been paid, then, to the extent of those funds advanced in reliance upon the false representation, the debt may be found to be nondischargeable.

F. Evaluate the Cost Effectiveness

A creditor should seriously evaluate the cost effectiveness of prosecuting a nondischargeability action before initiating the process. Such a proceeding is an adversary proceeding in bankruptcy court, which is a full trial under the federal rules of procedure and evidence, with opportunity for full discovery. A nondischargeability action is a creature arising exclusively from the Bankruptcy Code, and will be tried in the bankruptcy court without the prospect of withdrawing the reference and having the case transferred to federal district court. Bankruptcy judges are often debtor-oriented and may, at minimum, give the debtor/contractor the benefit of the doubt.

In evaluating the cost effectiveness of prosecuting a nondischargeability action, it is important to keep in mind that it may not perhaps be the entire debt owed to your client that is nondischargeable. Rather, it is only the part of the debt that arises from or is directly attributable to the specific act detailed in Section 523 that gives rise to the nondischargeability. Therefore, although your project owner client may be owed in excess of \$100,000 because of the cost of engaging completion contractors and paying unpaid subcontractors and vendors with mechanic's liens, if only \$10,000 or \$20,000 of that claim is attributable to reliance on misrepresentations in a pay application or lien waiver, then only that \$10,000 or \$20,000 will be held to be nondischargeable. The cost of litigation may, in the final analysis, equal or exceed the amount of the nondischargeability judgment.

G. *SO, WHAT DO YOU DO WHEN A PARTY ON A CONSTRUCTION PROJECT GOES BANKRUPT?*

- *Determine if the debtor may even receive a discharge – corporations do not.*
- *Evaluate the amount of debt that may actually be non-dischargeable. It likely is not the entire indebtedness owing to your client, but it may be.*
- *Evaluate the cost effectiveness of pursuing an adversary proceeding with your client to determine dischargeability of the debt.*

**XII.
CONCLUSION**

There can be no doubt that the filing of bankruptcy by a party on a construction project will, in the best case, cause many complications, and in the worse case result in liability to some to make double payments, sanctions for conduct in violation of bankruptcy laws and a general nightmarish existence for the sureties and owner on the project. Fortunately most cases fall between these two extremes and are entirely manageable so long as the parties have some familiarity with bankruptcy laws and their implications and heed them. By becoming and remaining informed of events and developments in the bankruptcy proceeding and developing at least a basic understanding of the relative rights of the respective parties associated with the bankruptcy case – even if that understanding comes from consultation with bankruptcy specialists

– a construction lawyer will be able to assist his client in determining what to do when a party on a construction project goes bankrupt.

TABLE OF CONTENTS TO APPENDICES

Appendix “A”	Notice of Appearance and Request for Notices.
Appendix “B”	Proof of Claim (Chapter 7 and 11).
Appendix “C”	Local Rule 4001 of Southern District of Texas.
Appendix “D”	Cover Sheet for Motion for Relief from Stay in Souther District of Texas.
Appendix “E”	Excerpt of contract language as discussed by the Fifth Circuit in <i>United Parcel Service</i> . 794 F.2d at 1008 (1986).
Appendix “F”	An example of some contract terms helping establish that a debtor/contractor with unpaid claimants is not entitled to contract proceeds.

CERTIFICATE OF SERVICE

I hereby certify that true and correct copies of the foregoing Notice of Appearance and Request for Service of Papers were mailed on **DATE** by United States First Class Mail and/or by Certified Mail, Return Receipt Requested, to the Debtor, Debtor's counsel, Chapter ____ Trustee, U.S. Trustee, and all parties as listed on the attached Service List.

ATTORNEY NAME

UNITED STATES BANKRUPTCY COURT _____ DISTRICT OF _____		PROOF OF CLAIM												
Name of Debtor _____		Case Number _____												
<p>NOTE: This form should not be used to make a claim for an administrative expense arising after the commencement of the case. A "request" for payment of an administrative expense may be filed pursuant to 11 U.S.C. § 503.</p>														
Name of Creditor (The person or other entity to whom the debtor owes money or property): _____		<input type="checkbox"/> Check box if you are aware that anyone else has filed a proof of claim relating to your claim. Attach copy of statement giving particulars. <input type="checkbox"/> Check box if you have never received any notices from the bankruptcy court in this case. <input type="checkbox"/> Check box if the address differs from the address on the envelope sent to you by the court.												
Name and address where notices should be sent: _____														
Telephone number: _____														
Account or other number by which creditor identifies debtor: _____		THIS SPACE IS FOR COURT USE ONLY												
Check here <input type="checkbox"/> replaces if this claim <input type="checkbox"/> amends a previously filed claim, dated: _____														
<p>1. Basis for Claim</p> <table style="width:100%;"> <tr> <td><input type="checkbox"/> Goods sold</td> <td><input type="checkbox"/> Retiree benefits as defined in 11 U.S.C. § 1114(a)</td> </tr> <tr> <td><input type="checkbox"/> Services performed</td> <td><input type="checkbox"/> Wages, salaries, and compensation (fill out below)</td> </tr> <tr> <td><input type="checkbox"/> Money loaned</td> <td>Last four digits of SS #: _____</td> </tr> <tr> <td><input type="checkbox"/> Personal injury/wrongful death</td> <td>Unpaid compensation for services performed</td> </tr> <tr> <td><input type="checkbox"/> Taxes</td> <td>from _____ to _____</td> </tr> <tr> <td><input type="checkbox"/> Other _____</td> <td>(date) (date)</td> </tr> </table>			<input type="checkbox"/> Goods sold	<input type="checkbox"/> Retiree benefits as defined in 11 U.S.C. § 1114(a)	<input type="checkbox"/> Services performed	<input type="checkbox"/> Wages, salaries, and compensation (fill out below)	<input type="checkbox"/> Money loaned	Last four digits of SS #: _____	<input type="checkbox"/> Personal injury/wrongful death	Unpaid compensation for services performed	<input type="checkbox"/> Taxes	from _____ to _____	<input type="checkbox"/> Other _____	(date) (date)
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<input type="checkbox"/> Personal injury/wrongful death	Unpaid compensation for services performed													
<input type="checkbox"/> Taxes	from _____ to _____													
<input type="checkbox"/> Other _____	(date) (date)													
2. Date debt was incurred: _____		3. If court judgment, date obtained: _____												
<p>4. Total Amount of Claim at Time Case Filed: \$ _____ (unsecured) _____ (secured) _____ (priority) _____ (Total)</p> <p>If all or part of your claim is secured or entitled to priority, also complete Item 5 or 7 below.</p> <input type="checkbox"/> Check this box if claim includes interest or other charges in addition to the principal amount of the claim. Attach itemized statement of all interest or additional charges.														
<p>5. Secured Claim.</p> <input type="checkbox"/> Check this box if your claim is secured by collateral (including a right of setoff). Brief Description of Collateral: <input type="checkbox"/> Real Estate <input type="checkbox"/> Motor Vehicle <input type="checkbox"/> Other _____ Value of Collateral: \$ _____ Amount of arrearage and other charges <u>at time case filed</u> included in secured claim, if any: \$ _____		<p>7. Unsecured Priority Claim.</p> <input type="checkbox"/> Check this box if you have an unsecured priority claim Amount entitled to priority \$ _____ Specify the priority of the claim: <input type="checkbox"/> Wages, salaries, or commissions (up to \$10,000),* earned within 180 days before filing of the bankruptcy petition or cessation of the debtor's business, whichever is earlier - 11 U.S.C. § 507(a)(3). <input type="checkbox"/> Contributions to an employee benefit plan - 11 U.S.C. § 507(a)(4). <input type="checkbox"/> Up to \$2,225* of deposits toward purchase, lease, or rental of property or services for personal, family, or household use - 11 U.S.C. § 507(a)(6). <input type="checkbox"/> Alimony, maintenance, or support owed to a spouse, former spouse, or child - 11 U.S.C. § 507(a)(7). <input type="checkbox"/> Taxes or penalties owed to governmental units-11 U.S.C. § 507(a)(8). <input type="checkbox"/> Other - Specify applicable paragraph of 11 U.S.C. § 507(a)(____). <small>*Amounts are subject to adjustment on 4/1/07 and every 3 years thereafter with respect to cases commenced on or after the date of adjustment. \$10,000 and 180-day limits apply to cases filed on or after 4/20/05. Pub.L. 109-8.</small>												
<p>6. Unsecured Nonpriority Claim \$ _____</p> <input type="checkbox"/> Check this box if: a) there is no collateral or lien securing your claim, or b) your claim exceeds the value of the property securing it, or if c) none or only part of your claim is entitled to priority.														
<p>8. Credits: The amount of all payments on this claim has been credited and deducted for the purpose of making this proof of claim.</p> <p>9. Supporting Documents: <i>Attach copies of supporting documents</i>, such as promissory notes, purchase orders, invoices, itemized statements of running accounts, contracts, court judgments, mortgages, security agreements, and evidence of perfection of lien. DO NOT SEND ORIGINAL DOCUMENTS. If the documents are not available, explain. If the documents are voluminous, attach a summary.</p> <p>10. Date-Stamped Copy: To receive an acknowledgment of the filing of your claim, enclose a stamped, self-addressed envelope and copy of this proof of claim</p>		THIS SPACE IS FOR COURT USE ONLY												
Date _____	Sign and print the name and title, if any, of the creditor or other person authorized to file this claim (attach copy of power of attorney, if any): _____													

Local Rule 4001. Relief from Automatic Stay

(a) Motions for relief from stay:

- (1) Motions for relief from the stay must contain a certificate that the movant has conferred with opposing counsel (or, in the event of *pro se* parties, opposing parties) and been unable to reach an agreement on the requested relief. If no conference has been conducted, movant must certify the dates and times on which movant has attempted to confer.
- (2) A motion for relief from stay must include a hearing date from the judge's web page. Failure to obtain a hearing date from the judge's web page and to include the notice in BLR 4001(a)(3) is a waiver of the automatic termination of the automatic stay under 11 U.S.C. § 362(e) or 1301(d).
- (3) The motion must state immediately below the title:

This is a motion for relief from the automatic stay. If it is granted, the movant may act outside of the bankruptcy process. If you do not want the stay lifted, immediately contact the moving party to settle. If you cannot settle, you must file a response and send a copy to the moving party at least two days before the hearing. If you file your response less than 5 days before the hearing, you must send a copy to the movant by facsimile, by hand, or by electronic delivery. If you cannot settle, you must attend the hearing. Evidence may be offered at the hearing and the court may rule.

Represented parties should act through their attorney.

There will be a hearing on this matter on [date] at [time] in courtroom _____, [address].

- (4) In addition to service as required by FED. R. BANKR. P. 4001(a)(1), on the same day that it is filed, the motion must be served on debtor, debtor's attorney, parties requesting notice, parties with an interest in collateral that is the subject of the requested relief, co-debtors under 11 U.S.C. § 1301, parties who are identified as a party against whom relief is sought in the motion, and the trustee.
- (5) If the moving party schedules a hearing on a motion for relief from stay or agrees to continue the hearing to a date more than thirty (30) days after the date the motion was filed (20 days for motions to lift the co-debtor stay), the party shall be deemed to have waived the automatic termination under 11 U.S.C. § 362(e) and/or 1301(d).

- (6) All motions to lift stay that request foreclosure on improved real property must be accompanied by documents evidencing the debt and lien perfection, and a payment history, including an explanation of transaction codes. Responses disputing the payment history must specify payments made that are not reflected in the payment history, the dates of payment, the amounts, and the mode. Evidence not accompanying the motion or response may be inadmissible in an evidentiary hearing.
 - (7) Failure of the movant to prosecute the motion at a preliminary hearing may result in dismissal of the motion for want of prosecution unless there is (i) an order continuing the hearing and waiving the 30-day requirement; (ii) a stipulation of the parties to continue the hearing and waive the 30-day requirement; or (iii) an agreed order resolving the motion that is entered prior to or is signed at the hearing.
 - (8) Motions for relief from the stay may never be combined with a request for other relief.
 - (9) In addition to other procedures applicable to motions for relief from the stay, a chapter 13 debtor must timely respond to motions for relief from the stay. A timely response includes the filing of an agreed order, a denial that conforms with FED. R. BANKR. P. 7008, a statement of nonopposition, or another accurate statement reflecting the current status of the motion. If no timely response is filed, the court may grant the motion for relief from the stay with or without a hearing, at its discretion.
 - (10) Responses should state the efforts of respondent to reach an agreement with movant and either (i) itemize each disputed issue of law or fact; or (ii) comply with FED. R. CIV. P. 8 as applied by FED. R. BANKR. P. 7008.
 - (11) In any evidentiary hearing conducted on a motion for relief from the automatic stay, all counsel shall certify before the presentation of evidence (1) that good faith settlement discussions have been held or why they have not been held; (2) that all exhibits, appraisals and lists of witnesses (the debtor is presumed to be a witness and need not be identified) have been exchanged at least two days in advance of the hearing date; and (3) the anticipated length of the hearing. Exhibits must be marked in advance of the hearing and a bound, marked set of exhibits must be presented to the court at the commencement of the hearing.
- (b) Motions filed under BR 4001(b), 4001(c), or 4001(d) for the use of cash collateral, obtaining credit, or for approval of agreements on BR 4001 matters, must state immediately below the title:

This motion seeks an order that may adversely affect you. If you oppose the motion, you should immediately contact the moving party to resolve the dispute. If you and the moving party cannot agree, you must file a response and send a copy to the moving party. You must file and serve your response within 15 days of the date this was served on you. Your response must state why the motion should not be granted. If you do not file a timely response, the relief may be granted without further notice to you. If you oppose the motion and have not reached an agreement, you must attend the hearing. Unless the parties agree otherwise, the court may consider evidence at the hearing and may decide the motion at the hearing.

Represented parties should act through their attorney.

If a hearing has been set on the motion, this language must be added at the end of the notice:

There will be a hearing on this motion on [date] at [time] in courtroom _____, [address].

- (c) Motions to approve agreements governed by Bankruptcy Rule 4001(d) must be served:
 - (1) If the agreement is in an individual chapter 7 case or a chapter 13 case and concerns consumer goods, the debtor's homestead or a non-business-use vehicle, notice should be given to the chapter 13 trustee, the debtor, any co-obligor, and any party with an interest in the collateral.
 - (2) Motions to approve all other agreements governed by Bankruptcy Rule 4001(d) shall be served under BLR 2002(a)(3).
- (d) Attorneys' fees will be awarded to creditors for filing motions for relief from the stay as follows:
 - (1) Undersecured creditors will not be awarded attorneys' fees for the filing of a motion for relief from the stay in a chapter 13 bankruptcy case.
 - (2) With respect to motions by oversecured creditors or by home lenders filing post-confirmation motions governed by § 1322(b)(2), the court will approve agreed orders (i) providing for attorneys' fees and costs not to exceed \$500.00 plus statutory filing fees; and (ii) providing for attorneys' fees and costs exceeding that sum only upon a submission of fee statements reflecting actual time incurred. All requests for attorneys' fees must (i) include a certification that the amount requested is less than or equal to the amount that will be paid by the holder of the lien to the holder's counsel; and (ii) be reasonable under the facts and circumstances.

- (3) Attorneys' fees in matters not resolved by agreed orders will be considered on an evidentiary basis.
- (e) In each chapter 13 case, the Court will issue an order that authorizes the use of estate vehicles under § 363 and provides adequate protection to the holders of liens on the vehicles.
- (1) The adequate protection order will require the debtor to (i) maintain insurance on the vehicle in the amount required by the debtor(s) prepetition contract; (ii) provide proof of insurance to the lien holder; and (iii) enter into a wage order or EFT Order not later than the date of the § 341 meeting of creditors.
 - (2) As additional adequate protection, the lien holder will be given an administrative claim, with priority under § 507(b), in an amount equal to 1.5% of the value of the vehicle for each 30 days that elapses from the date of the adequate protection order. For example, if the vehicle is valued at \$10,000, a § 507(b) adequate protection claim in the amount of \$150 will accrue each month. In the event of a dismissal or conversion of the chapter 13 case, the trustee will distribute the proceeds in accordance with § 1326(a)(2). This will result, in most cases, in payments being made in the following order of priority:
 - (A) First, to the vehicle lien holders in the amount of the adequate protection reserve;
 - (B) Second, to debtor's counsel for unpaid fees for which an application is filed on or before 20 days after entry of the order of dismissal and that have been allowed by court order;
 - (C) Third, to the debtor (directly and not through counsel).
 - (D) Payments under paragraph "1" shall be made following the expiration of 10 days of entry of the dismissal order, unless the dismissal order is stayed.
 - (3) The debtor or any other party in interest may object to the adequate protection order not later than 10 days after entry of the court's order. The objecting party must state the date that the hearing will be conducted, which date will be the next chapter 13 panel after the expiration of 15 days from the date of the objection. The objection must be served on the debtor, the debtor's counsel, the chapter 13 trustee, and any party holding security interest in the vehicle. The objecting party must attend the hearing and present evidence in support of the objection.

- (4) For purposes of valuation, the vehicle value will be determined as of the date of the filing of the chapter 13 petition. In determining the principal amount due to the lien holder under the plan, the § 507(b) payments will be (i) deducted from the value of the vehicle, if the value of the vehicle is less than the lien, resulting in a Confirmation Date Value; and (ii) applied to interest if the value of the vehicle is greater than the lien. If the value of the vehicle is less than the lien, interest will begin to accrue on the confirmation date based on the Confirmation Date Value.
 - (5) The adequate protection order will not provide protection to a vehicle lender if the debtor voluntarily surrenders the vehicle by delivering the vehicle to the vehicle lender within 30 days of the petition date.
- (f) Motions for relief from the automatic stay that pertain to exempt residences or exempt vehicles (“Consumer Lift Stay Motions”) are governed by this BLR 4001(f).
- (1) Parties who file motions for relief from the stay on exempt residences or exempt vehicles in chapter 7 and chapter 13 cases must comply with this BLR 4001(f) and must use the forms promulgated by the court from time to time.
 - (2) Variance from this rule is allowed, if exceptional circumstances exist. A.
 - A. Exceptional circumstances include:
 - 1. A motion for relief from the stay filed against a repeat bankruptcy case filer for which the movant seeks relief other than a routine termination of the stay; or
 - 2. A motion for relief from the stay on which there are disputes regarding the extent, validity, or priority of liens on the collateral that is the subject of the motion.
 - B. A party believing that are other exceptional circumstances justifying exemption from this rule must allege the exceptional circumstances with particularity in the motion.
 - (3) Variance from this rule is allowed, if exceptional circumstances exist. When exceptional circumstances are alleged, the court may conduct an evidentiary hearing at which time the exceptional circumstances must be demonstrated by a preponderance of the evidence.
 - (4) Prior to filing a Consumer Lift Stay Motion, the movant must attempt to contact the debtor(s)’ counsel to discuss whether an agreement can be reached utilizing the court’s agreed order forms. If such an agreement can be

reached, the parties may submit a Motion for Entry of Agreed Order under FRBP 4001. Submission of an order under such circumstances avoids the expense of preparing a motion for relief, the filing fee for a motion for relief, the expense of filing a response to the motion, and the expense of attending a hearing. Conferences may be attempted by telephone or by e-mail. If no response is received within 2 business days, the motion may be filed without an actual conference. In all conferences, movant's counsel must provide a contact person with a direct telephone number for future discussions.

- (5) If the parties cannot reach agreement to submit an agreed order in the court's format, the party seeking relief from the stay may file a Consumer Lift Stay Motion in the court's format along with a proposed order, also in the court's format. Responses by the debtor must be one of the following and must be filed at least five days before the hearing:
 - (A) Submission of an agreed order terminating the stay utilizing a form from the court's website. If an agreed order is filed in accordance with these procedures, the court usually will issue the order prior to the hearing. Attendance at the originally scheduled hearing is not necessary, by either party. If the court declines to issue the order, the court will issue an order for further proceedings.
 - (B) Submission of an agreed order conditioning the stay utilizing a form from the court's website. If an agreed order is filed in accordance with these procedures, the court will usually issue the order prior to the hearing. Attendance at the originally scheduled hearing is not necessary, by either party. If the court declines to issue the order, the court will issue an order for further proceedings.
 - (C) Filing an answer or other response. Answers must comply with FRBP 9011. Responses must be based on reasonable investigation and must not be filed for delay or other improper purpose. A response stating that the debtor(s)' attorney has not been able to contact the debtor(s) or a general denial not based on reasonable investigation may not be sufficient to prevent default relief. If a timely response is filed, attendance at the hearing by both parties is required.
- (6) If a sufficient response has not been timely filed, the movant must submit a proposed form of default order with a certification of default. The proposed form of default order and certification must comply with the court's form as promulgated from time to time. The court may issue a default order if an adequate response is not filed at least five days before the hearing. If the court issues a default order prior to the hearing, counsel need not appear at the hearing. If the court has not issued a default order and a party who has failed to respond appears at the hearing, the court may nevertheless grant default relief or may set a date for an evidentiary hearing.

B104 (Rev. 2/92)	ADVERSARY PROCEEDING COVER SHEET (Instructions on Reverse)	ADVERSARY PROCEEDING (Court Use Only)
PLAINTIFFS		DEFENDANTS
ATTORNEYS (Firm Name, Address, and Telephone No.)		ATTORNEYS (If Known)
PARTY (Check one box only) 1 U.S. PLAINTIFF 2 U.S. DEFENDANT 3 U.S. NOT A PARTY		
CAUSE OF ACTION (WRITE A BRIEF STATEMENT OF CAUSE OF ACTION, INCLUDING ALL U.S. STATUTES INVOLVED)		
NATURE OF SUIT (Check the one most appropriate box only.)		
454 To Recover Money or Property 435 To Determine Validity, Priority, Extent of a Lien or Other Interest in Property 458 To obtain approval for the sale of both the interest of the estate and of a co-owner in property 424 To object or to revoke a discharge 11 U.S.C. § 727	455 To revoke an order of confirmation of a Chap. 11, Chap. 12, or Chap. 13 Plan 426 To determine the dischargeability of a debt 11 U.S.C. § 523 434 To obtain an injunction or other equitable relief 457 To subordinate any allowed claim or interest except where such subordination is provided in a plan	456 To obtain a declaratory judgment relating to any of the foregoing causes of action 459 To determine a claim or cause of action removed to a bankruptcy court 498 Other (specify)
ORIGIN OF PROCEEDINGS (Check one box only.)	1 Original Proceeding 2 Removed Proceeding 4 Reinstated or Reopened 5 Transferred from Another Bankruptcy Court	CHECK IF THIS IS A CLASS ACTION UNDER F.R.C.P. 23
DEMAND	NEAREST THOUSAND	OTHER RELIEF SOUGHT
BANKRUPTCY CASE IN WHICH THIS ADVERSARY PROCEEDING ARISES		
NAME OF DEBTOR		BANKRUPTCY CASE NO.
DISTRICT IN WHICH CASE IS PENDING	DIVISIONAL OFFICE	NAME OF JUDGE
RELATED ADVERSARY PROCEEDING (IF ANY)		
PLAINTIFF	DEFENDANT	ADVERSARY PROCEEDING NO.
DISTRICT	DIVISIONAL OFFICE	NAME OF JUDGE
FILING FEE (Check one box only.)	FEE ATTACHED	FEE NOT REQUIRED
		FEE IS DEFERRED
DATE	PRINT NAME	SIGNATURE OF ATTORNEY (OR PLAINTIFF)

ADVERSARY PROCEEDING COVER SHEET (Reverse Side)

This cover sheet must be completed by the plaintiff's attorney (or by the plaintiff if the plaintiff is not represented by an attorney) and submitted to the clerk of the court upon the filing of a complaint initiating an adversary proceeding.

The cover sheet and the information contained on it *do not* replace or supplement the filing and service of pleadings or other papers as required by law, the Federal Rules of Bankruptcy Procedure, or the local rules of court. This form is required for the use of the clerk of the court to initiate the docket sheet and to prepare necessary indices and statistical records. A separate cover sheet must be submitted to the clerk of the court for each complaint filed. The form is largely self-explanatory.

Parties. The names of the parties to the adversary proceeding *exactly* as they appear on the complaint. Give the names and addresses of the attorneys if known. Following the heading "Party," check the appropriate box indicating whether the United States is a party named in the complaint.

Cause of Action. Give a brief description of the cause of action including all federal statutes involved. For example, "Complaint seeking damages for failure to disclose information, Consumer Credit Protection Act, 15 U.S.C. § 1601 et seq.," or "Complaint by trustee to avoid a transfer of property by the debtor, 11 U.S.C. § 544."

Nature of Suit. Place an "X" in the appropriate box. Only one box should be checked. If the cause fits more than one category of suit, select the most definitive.

Origin of Proceedings. Check the appropriate box to indicate the origin of the case:

1. Original Proceeding.
2. Removed from a State or District Court.
4. Reinstated or Reopened.
5. Transferred from Another Bankruptcy Court.

Demand. On the next line, state the dollar amount demanded in the complaint in thousands of dollars. For \$1,000 enter "1," for \$10,000 enter "10," for \$100,000 enter "100," if \$1,000,000, enter "1000." If \$10,000,000 or more, enter "9999." If the amount is less than \$1,000, enter "0001." If no monetary demand is made, enter "XXXX." If the plaintiff is seeking non-monetary relief, state the relief sought, such as injunction or foreclosure of a mortgage.

Bankruptcy Case in Which This Adversary Proceeding Arises. Enter the name of the debtor and the docket number of the bankruptcy case from which the proceeding now being filed arose. Beneath, enter the district and divisional office where the case was filed, and the name of the presiding judge.

Related Adversary Proceedings. State the names of the parties and the six digit adversary proceeding number from any adversary proceeding concerning the same two parties or the same property currently pending in any bankruptcy court. On the next line, enter the district where the related case is pending, and the name of the presiding judge.

Filing Fee. Check one box. The fee must be paid upon filing unless the plaintiff meets one of the following exceptions. The fee is not required if the plaintiff is the United States government or the debtor. If the plaintiff is the trustee or a debtor in possession, and there are no liquid funds in the estate, the filing fee may be deferred until there are funds in the estate. (In the event no funds are ever recovered for the estate, there will be no fee.) There is no fee for adding a party after the adversary proceeding has been commenced.

Signature. This cover sheet must be signed by the attorney of record in the box on the right of the last line of the form. If the plaintiff is represented by a law firm, a member of the firm must sign. If the plaintiff is *pro se*, that is, not represented by an attorney, the plaintiff must sign.

The name of the signatory must be printed in the box to the left of the signature. The date of the signing must be indicated in the box on the far left of the last line.

**EXCERPT OF LANGUAGE BY THE FIFTH CIRCUIT IN
*UNITED PARCEL SERVICE, 794 F.2D AT 1008 (1986)***

“CONTRACTOR for itself and its subcontractors, material suppliers and employees, hereby expressly waives the right to file any lien or claim against the premises; and further, that if in violation thereof, there shall be any lien, or other claim for monies due or to become due for which if established, UPS might be liable, and which would be chargeable to the CONTRACTOR, CONTRACTOR shall immediately satisfy or bond the same, or UPS shall have the right to bond said lien or claim or otherwise discharge the same and to retain out of any payment then due or thereafter to become due, an amount sufficient to completely indemnify it against such lien or other claim with interest together with the expense incident to discharging such lien or claim or defending suit to enforce such lien or other claim, including any premiums charged for a bond and any attorney’s fees and disbursements all of which the CONTRACTOR agrees to pay. . .

CONTRACT TERMS THAT WILL HELP DEFEAT DEFAULTING DEBTOR/CONTRACTOR'S CLAIM TO CONTRACT PROCEEDS

The following terms or similar terms should be included in an owner's contract with a general contractor or a general contractor's contract with subcontractors to increase the likelihood that a bankruptcy judge will determine that contract proceeds of the defaulting debtor/contractor are **NOT** property of the estate and therefore they may be utilized by the owner of general contractor to satisfy unpaid claims.

1. All payments due or to become due will be held as trust funds and shall be applied first to the payment of subcontractors, sub-subcontractors, laborers, employees, and suppliers, and will not be used for any other purpose until those persons are paid in full.
2. The contractor [subcontractor], for itself and its subcontractors, sub-subcontractors, laborers, employees, and suppliers hereby expressly waives the right to file any lien or claim against the premises. If in violation of this waiver there shall be any lien, or any claim for monies due or to become due for which if established, owner [contractor] might be liable and which would be chargeable to contractor [subcontractor], contractor [subcontractor] shall immediately satisfy or bond around the same, and owner [contractor] will be indemnified and held harmless from any lien or claim filed or made by any third person or firm because of alleged non-payment for labor, materials, or services furnished or performed. Provided, however, that owner [contractor] shall have the right to bond around said lien or claim or otherwise discharge the same and to retain out of any payment then due or thereafter to become due to contractor [subcontractor], including any retainage fund, an amount sufficient to completely indemnify it against such lien or other claim with interest together with the expenses incident to discharging such lien or claim or defending suit to enforce such lien or such claim, including any premiums charged for a bond and any attorney's fees and disbursements all of which the contractor [subcontractor] agrees to pay.
3. Any liens or other encumbrances against the project must be prevented or removed, and all claims for labor, materials, or services furnished or performed on the project must be paid promptly.
4. Payments to be made under this contract shall be made on the express condition that all persons furnishing labor or materials in connection with the work having been paid in full, and that none of those persons has filed, or has the right to maintain, a lien or other claim against the other, the contractor, the contractor's surety, or the project itself. Submittal of a pay

application by contractor [subcontractor] constitutes a certification of satisfaction of these conditions.

5. Any funds paid by owner [or general contractor] to satisfy or bond around liens or claims, and any expenses associated therewith, in order to remedy a default by contractor [or subcontractor] shall be deemed backcharges against the contract price. If the contract is terminated, or if a petition for relief under the bankruptcy code is filed and the contract has not been assumed or rejected under 11 U.S.C. § 365, no further payments shall be made to contractor [or subcontractor] until the work is completed and assumption of the contract is approved by the bankruptcy court.