

Daniel J. Garfield

**PRESERVING A CONTRACTOR'S MECHANIC'S LIEN, TRUST
FUND, AND CONTRACT RIGHTS BEFORE AND IN BANKRUPTCY**

Contractors, developers, and lenders know the risks that come from unfinished or delayed projects and unpaid work. For that reason best practices have always included tracking first visible work, last day of work, and other issues important to perfecting and enforcing mechanic's lien and trust fund rights. The potential or actual bankruptcy of a project participant introduces new challenges and risks which can be managed efficiently and cost-effectively with prudent planning and risk management. Parties in a bankruptcy case are subject to the expense and uncertainty inherent in all litigation.

Pre-bankruptcy planning

Because bankruptcy stops all collection efforts against the debtor (but not others who might be liable), pre-bankruptcy planning and monitoring at the first sign of a party's financial distress is essential. A critical step in managing bankruptcy risk is terminating nonperforming contracts, if legally and practically feasible, as soon as possible. Termination after a bankruptcy filing will likely be time-consuming and costly (if a bankrupt party remains in business and objects to termination) and will require court approval, always uncertain. Monitoring a distressed party's funds held in trust for payment is also crucial, although obtaining those records might be difficult unless required by contract.

Bankruptcy is entirely a creation of federal law (but property rights remain defined by state law), and bankruptcy cases are administered in a federal bankruptcy court in each federal judicial district (for Colorado, the district is the entire state). Bankruptcies can be voluntary (filed by the debtor) or, less typically, involuntary (filed by three or more unsecured creditors). Bankruptcies are categorized by chapter of the Bankruptcy Code. Chapter 7 bankruptcy is a liquidation in which a business immediately ceases operations, and a trustee is appointed to liquidate assets and distribute proceeds to creditors based upon their state law rights. Chapter 11 bankruptcy is a reorganization (and sometimes a liquidation) in which the debtor remains in business and proposes a plan to reorganize its finances and pay its creditors. (There are other types of bankruptcy cases, but they are typically not relevant to the construction industry).

Once a bankruptcy is filed, two important things occur: a) the "automatic stay" protects the debtor from creditor collection efforts, including efforts related to liens and cancellation of contracts; and b) a "bankruptcy estate" is created consisting of all of the debtor's assets; distributions to creditors will come from this estate. An important exception to the automatic

stay is that a mechanic's lien can be perfected after a bankruptcy filing so long as the time to perfect has not run under Colorado law. Mechanic's lienholders may seek relief from the bankruptcy court in certain circumstances (e.g., the debtor has no equity in the property and the property is not necessary for an effective reorganization) to modify the automatic stay to proceed with a foreclosure or enforce other state law rights.

The automatic stay provides a Chapter 11 debtor time to assess and reorganize its assets and liabilities in return for turning over its assets to pay creditors in an orderly fashion. The establishment of a bankruptcy estate, in turn, reassures creditors that their claims will be resolved in one forum, and similarly situated parties (e.g., secured creditors, unsecured creditors, employees, owners), will be treated similarly, regardless of whether a creditor prior to bankruptcy began enforcing its rights.

If a nonperforming contract was not terminated post-bankruptcy, and the debtor continues to fail to perform, the performing party must seek court approval to force the debtor to perform or to reject the contract. Hiring another contractor or subcontractor to complete unfinished work by a non-terminated debtor has serious risks: the debtor or trustee might argue that the contract is assignable and that assignment will yield some monetary or other benefit to the bankruptcy estate. However, this must be balanced against other risks to the project, such as timely completion. Chapter 11 debtors that remain in business can delay their decision (unless a contract counterparty asks the court to force the debtor to make a quicker decision) to perform under outstanding "executory" contracts (where both parties have outstanding material obligations). Assumption (and any assignment) of the contract requires the debtor to cure any defaults and immediately begin performing. Rejection leads to a breach of the contract, and the counterparty may then use its contract rights to replace the debtor if necessary. These concepts apply not only to suppliers and subcontractors delivering materials or providing labor, but also to engineers, design professionals, and any other party that provides license rights (e.g., plans) for a project.

As a general matter, a bankrupt property owner will be able to sell property free and clear of a mechanic's lien, but the lien will attach to the sale proceeds to the same extent, priority, and validity that the lien has under state law. Nevertheless, lienholders must be vigilant to ensure that a bankruptcy court's order approving such a sale protects the lienholder's rights.

An oft-litigated subject is a demand from a trustee or debtor for payments made in the 90 days prior to the bankruptcy filing. Known as preferences or preferential payments, payments to unsecured creditors during this time period might be at risk. Any settlement or other payment made in the 90-day preference period with a financially distressed debtor should be evaluated for potential preference exposure. Payments to secured creditors, including mechanic's lienholders, are not susceptible to such liability, so it is incumbent that a potential lienholder perfect a lien as soon as possible and to document a lien release upon final payment.

A pre-bankruptcy violation of the Colorado trust fund statute by a general contractor or subcontractor can prove useful in the bankruptcy setting, particularly where the violator's principal has also filed bankruptcy. If a trust fund violation has occurred, the unpaid creditor can file a complaint objecting to the discharge of the debt, including treble damages.

Monitoring project participants for financial distress is a critical part of managing project risk. You should discuss with an attorney how to manage and minimize those risks. If you receive notice of a bankruptcy, you should contact an attorney immediately. Bankruptcy deadlines are often much shorter than other types of litigation, and you can lose important rights if you do not act timely.