

AND THE WALLS CAME TUMBLING DOWN:
ISSUES IN U.S. CONSTRUCTION INSOLVENCIES

Judith Elkin
David Liebenstein
HAYNES AND BOONE, LLP
New York, NY

ANNUAL MEETING OF THE INTERNATIONAL BAR ASSOCIATION
Section on Insolvency Restructuring and Creditors' Rights
Madrid, Spain
4 – 9 October 2009

And the Walls Came Tumbling Down: Issues in U.S. Construction Insolvencies

By: Judith Elkin and David Liebenstein¹

Introduction

We are in the midst of arguably the worst economic crisis since the Great Depression. One of the biggest victims of this meltdown is the construction industry, both residential and commercial, which has been hit as hard, if not harder, than any industry in the United States. Prior to Spring of 2007, the easy availability of credit and the escalation of real estate values created boom times for those involved in both the residential and commercial real estate markets. Houses, apartments, office buildings and hotels were all being built and financed with reckless abandon. But the 2007 crash in the subprime housing market created a domino effect, and by 2008, all sectors of the real estate and construction industries were seeing red. Both the residential and commercial construction markets have suffered mightily because of the housing crisis, the unavailability of credit, the inability of businesses to refinance debt and the general global economic downturn.

Because of the tight credit market, in June 2009, private housing starts were at a seasonally adjusted rate of 562,000, 46% lower (+/- 4.3%) than the June 2008 rate of 1,078,000.² In June 2009, privately-owned housing completions were at a seasonally adjusted rate of 818,000, 27.7% lower (+/- 9%) than the June 2008 rate of 1,131,000.³ Construction spending has also taken a precipitous decline. Total private construction was down 17.4% year over year.⁴

¹ Judith Elkin is a partner at the Bankruptcy and Business Reorganization Section of the law firm of Haynes and Boone, LLP. Ms. Elkin is resident in the firm's New York office, and has in excess of 25 years' experience representing debtors, creditors and other parties in interest in US and international insolvency cases. David Liebenstein is an associate in the Bankruptcy and Business Reorganization Section of Haynes and Boone, LLP and is also resident in the New York office.

² U.S. Census Bureau News Joint Release, U.S. Department of Housing and Urban Development, July 17, 2009.

³ *Id.*

⁴ U.S. Census Bureau Manufacturing, Mining, and Construction Statistics, Construction Spending, May 2009.

Because of the impact of the economy on the construction industry, a variety of high-profile construction-related bankruptcy cases have been filed recently. On January 29, 2008, Florida-based, Touse, Inc., the 13th largest home builder in the U.S. in 2006, filed for chapter 11 bankruptcy protection.⁵ On August 4, 2008, WCI Communities, Inc., a developer, builder and seller of luxury homes filed for chapter 11 protection.⁶ On June 9, 2009, Fontainebleau Las Vegas LLC, a retail construction project in Las Vegas, Nevada filed for chapter 11 protection.⁷ These is just a sampling of major construction industry companies falling into the bankruptcy. And for every major construction company debtor, there are dozens of industry suppliers – providers of lumber, air conditioners, windows, and the like – that are forced to follow the same path.

Due to the spate of construction industry bankruptcy filings, it is important to understand the legal issues unique to a construction bankruptcy. Among others, these issues may include statutory mechanic's liens, bonds (payment and performance), trusts (statutory, express and constructive), preferences, products liability (such as Chinese drywall) and construction financing. Affected constituencies of insolvent construction companies need to understand how an owners/developers, general contractors and/or subcontractors can protect themselves when a party to a construction project files for bankruptcy.

⁵ See *In re Touse, Inc.*, Case No. 08-10928 (JKO) (jointly administered), United States Bankruptcy Court, Southern District of Florida.

⁶ See *In re WCI Communities, Inc.*, Case No. 08-11643 (KJC) (jointly administered), United States Bankruptcy Court, District of Delaware.

⁷ See *In re Fontainebleau Las Vegas Holdings, LLC*, Case No. 09-21481-BKC-AJC (jointly administered), United States Bankruptcy Court, Southern District of Florida.

Statutory Liens

What are Mechanic's Liens?

A mechanic's or materialman's lien is a statutory lien on real property, put in place by a party that improves the property by providing goods or services at the behest of the owner, for the value provided.⁸ Every state⁹ provides some form of statutory construct that gives the value provider the ability to obtain satisfaction for unpaid work via the imposition of a lien on real property.¹⁰ If the property owner induced an improvement to its property, the owner should be required to compensate the laborer for such work.¹¹ Generally, any person who provides improvements to land may file a mechanic's or materialman's lien claim.¹²

How does a Mechanic's Lien Arise?

To successfully create and perfect¹³ a mechanic's lien, there must be a public filing (which puts other parties on notice) and service of the filing, during or after completion of the work.¹⁴ For example, under New York's Mechanic's lien law "[n]otice of lien may be filed at any time during the progress of the work and the furnishing of materials, or within eight months after the completion of the contract, or the final performance of the work, or the final furnishing

⁸ Joseph J. Wielebinski, Eric J. Spett, "Don't Lien On Me" *Construction Law Issues in Bankruptcy*, Advanced Business Bankruptcy Course, Chapter 10, May 17-18, 2001.

⁹ Because mechanic's lien laws vary by state, a lienor must be aware of a specific states law to ensure compliance with the relevant local statute.

¹⁰ For example, Texas provides self-executing Constitutional liens for original contractors for improvements made to property. *See* Tex. Const. art. XVI, § 37. A subcontractor can be deemed to be an original contractor if it can show (i) that the owner ordered work or materials directly from it; or (ii) that there is a sham contract between the owner and the original contractor. *See* Tex Prop. Code § 53.026.

¹¹ *Midwest Env'tl. Consulting & Remediation Servs., Inc. v. Peoples Bank of Bloomington*, 620 N.E.2d 469, 472 (Ill. App. Ct. 1993).

¹² *Id.* at 472-473.

¹³ Perfection of security interest – In secured transaction law, the process whereby a security interest is protected, as far as the law permits, against competing claims to the collateral which usually requires the secured party to give public notice of the interest as by filing in a government office (e.g. in office of Secretary of State). Perfection of a security interest deals with those steps legally required to give a secured party an interest in subject property against debtor's creditors. *See Deluxe Blacks Law Dictionary* at p. 1137 (6th Edition).

¹⁴ Lawrence Ponoroff, *Construction Claims In Bankruptcy: Making The Best Of A Bad Situation*, 11 Bankr. Dev. 343 1994-1995.

of materials, dating from the last item of work performed or materials furnished”¹⁵ In addition, the lienor must inform the owner that the lien has been filed. In New York, this must occur within five days before or thirty days after the public filing of the lien.¹⁶ Because of the variance from state to state, the timelines/deadlines and method of filing/perfecting the relevant mechanic’s lien statute must be consulted. While New York provides eight months after the completion of the work, other states may not be as generous. Perfection must be done according to the laws of the state in which the real property is located, not the state in which the contractor or owner may have legal residence.

Who Can Create a Mechanic’s Lien?

Almost universally, state mechanic’s lien laws are designed to protect any party who had a hand in making an improvement to a parcel of land. For example, under New York’s Mechanic’s Lien Law, “a contractor, subcontractor, laborer, materialmen, landscape gardener, nurseryman or person or corporation selling fruit or ornamental trees, roses, shrubbery, vines and small fruits, who performs labor or furnishes materials for the improvement of real property with the consent or at the request of the owner ...” may obtain a mechanic’s lien.¹⁷ Under Illinois law, contractors such as architects, structural engineers, professional engineers, land surveyors, or property managers can claim mechanic’s liens.¹⁸ This broad array of parties that have access to a mechanic’s lien is typical of most state statutes.

¹⁵See New York Consolidated Laws, Chapter 33, Article 2 Mechanic’s Liens (“NY Lien Law”) § 10 part 1. Filing of notice of lien. In addition, there is an exception for work done to single family dwellings; liens on those properties must be filed within four months of completion of the work. As another example, under Georgia law, the ‘mechanic’ must file record of its lien within three months after the completion of the work, and at the time of filing the record, send notice of the claim to the owner or contractor of the property, as agent for the owner. See Ga. Code Ann. § 44-14-361.1(a)(2) (1994).

¹⁶ See N.Y. Lien Law at § 11.

¹⁷ See N.Y. Lien Law at § 3. Under Texas law, three categories of persons are entitled to a lien: (1) suppliers of labor or materials; (2) persons specifically fabricating materials; and (3) certain design professionals. See Tex Prop. Code §§ 53.021(a), 53.001(3)(4), 53.021(b), 53.023 and 53.021(c).

¹⁸ Mechanic’s Lien Act (Ill.Rev.Stat.1991, ch. 82, par. 1).

Improvements Covered by Mechanic's Liens?

Generally, all labor and materials improving real property are subject to the protection of a mechanic's lien. For example, under Texas law¹⁹, 'labor' is defined as "labor used in the direct prosecution of the work" and 'material' "means all or part of: (A) the material, machinery, fixtures, or tools incorporated into the work, consumed in the direct prosecution of the work, or ordered and delivered for incorporation or consumption; (B) rent at a reasonable rate and actual running repairs at a reasonable cost for construction equipment used or reasonably required and delivered for use in the direct prosecution of the work at the site of the construction or repair; or (C) power, water, fuel, and lubricants consumed or ordered and delivered for consumption in the direct prosecution of the work."²⁰ Different jurisdictions may provide protection for different types of improvements.²¹

Relation Back of a Mechanic's Liens

The relation back doctrine is a legal concept which provides that an act is made to produce the same effect as if it had occurred at an earlier time. As long as the mechanic's lien is timely and properly perfected, it typically relates back to (i) the date the construction project

¹⁹ See Tex. Prop. Code § 53.001(3).

²⁰ For example, under Texas lien law, the inception of a mechanic's lien "is the commencement of construction of improvements or delivery materials to the land on which the improvements are to be located and on which the materials are to be used." Further, for delivery of materials, "the construction materials must be visible from inspection of the land on which the improvements are being made." See Tex Prop. Code § 53.124(a),(b).

²¹ NY Lien Law defines 'Improvement' to include the demolition, erection, alteration or repair of any structure upon, connected with, or beneath the surface of, any real property and any work done upon such property or materials furnished for its permanent improvement, and shall also include any work done or materials furnished in equipping any such structure with any chandeliers, brackets or other fixtures or apparatus for supplying gas or electric light and shall also include the drawing by any architect or engineer or surveyor, of any plans or specifications or survey, which are prepared for or used in connection with such improvement and shall also include the value of materials actually manufactured for but not delivered to the real property, and shall also include the reasonable rental value for the period of actual use of machinery, tools and equipment and the value of compressed gases furnished for welding or cutting in connection with the demolition, erection, alteration or repair of any real property, and the value of fuel and lubricants consumed by machinery operating on the improvement, or by motor vehicles owned, operated or controlled by the owner, or a contractor or subcontractor while engaged exclusively in the transportation of materials to or from the improvement for the purposes thereof and shall also include the performance of real estate brokerage services in obtaining a lessee for a term of more than three years of all or any part of real property to be used for other than residential purposes pursuant to a written contract of brokerage employment or compensation.

began, or (ii) the date the perfecting party first brought labor and/or materials to the construction site. This may allow a lienor to have its lien become effective prior to the date of a bankruptcy filing even if the lien had not been perfected prior the date the bankruptcy petition was filed. Once the lien is perfected, it provides the lienor with priority (the right to receive satisfaction of one's claim first) over any party that perfected after the relation back date.²²

Bankruptcy Implications of Mechanic's Liens

Bankruptcy law, for the most part, does not operate to annul state law, though it is designed to give a debtor the tools to reorganize. Perfection of a lien will be recognized under U.S. bankruptcy law to the extent the lien is perfected under applicable state law.

The Automatic Stay

Upon the filing of a bankruptcy petition, most creditor collection activities, such as filing or continuing lawsuits or initiating foreclosure measures, are prohibited. Certain activities, such as the ability to perfect mechanic's liens may not be stayed by the filing of the bankruptcy petition.²³ Section 362(b)(3) of the Bankruptcy Code permits mechanics and materialmen to perfect or maintain the perfection of their liens after the bankruptcy petition is filed.²⁴ In accordance with Section 546(b) of the Bankruptcy Code, if state law commands the taking of property or the commencement of an action to perfect a lien and these actions have not been done prior to the filing of the petition, then the lienor is allowed to perfect after the petition is filed. This is done by providing notice pursuant to the time ascribed in the relevant state statute. Section 546(b) is designed to "protect, in spite of the surprise intervention of the bankruptcy

²³ 11 U.S.C. § 362(b)

²⁴ 11 U.S.C. § 362(b)(3) provides in pertinent part: "The filing of a petition under section 301, 302, or 303 of this title, ... does not operate as a stay – 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."

petition, those whom state law protects by allowing them to perfect their liens or interests as of an effective date that is earlier than the date of perfection.”²⁵

Although Congress designed Section 546 as a powerful tool to protect potential lienors, it failed to specify the manner of the notice and timing requirements. As a result, Courts have been left to determine the requirements for themselves. Courts have held that when state law requires the commencement of an action in order to perfect a lien, post-petition, which would otherwise be a violation of the automatic stay, then the filing of a secured claim in the Bankruptcy Court is sufficient.²⁶ Because of court applications may vary, a lienor must stay apprised of the local jurisdiction’s rule of law to ensure proper filing and perfection.

As a general rule of thumb, the Bankruptcy Code allows perfection of a lien, but actions taken to enforce a lien or collect on the underlying debt would violate the automatic stay.²⁷

Non-Debtor Third-Parties

While the automatic stay was designed to shield the debtor, generally, it cannot be used as a shield by non-debtor third-parties. Therefore, there is nothing preventing a subcontractor from employing all necessary measures to perfect and enforce its lien against a non-debtor general contractor (or other third party, including sureties and guarantors) who may be liable on its claim.²⁸ Under certain circumstances, however, if the non-debtor third-party is inextricably linked to the debtor, a court may extend the automatic stay to protect the non-debtor third-party

²⁵ *Collier on Bankruptcy*, ¶ 546.03[1] (15th Ed. Rev.) (citing S. Rep. No. 989, 95th Cong. 2d., 2d Sess. 86-87 (1978), reprinted in App. Pt. 4(e)(i) *infra*; H.R. Rep. No. 595, 95th Cong., 1st Sess. 371-372 (1977), reprinted in App. Pt. 4(d)(i) *infra*.)

²⁶ See e.g., *In re Sampson*, 57 B.R. 304, 309 (Bankr. E.D. Tenn. 1986) (finding that in order to be sufficient, notice had to be filed with the Bankruptcy Court); *In re Gelwicks*, 81 B.R. 445, 447 (Bankr. N.D. Ill. 1987) (“notice is sufficient if it informs the court or the possessor of the property that the creditor intends to enforce its lien.”).

²⁷ See *In re Cook*, 384 B.R. 282 (Bankr. N. D. Ala. 2008) (filing with circuit court seeking enforcement of a lien was violation of the automatic stay and the creditor should have given notice in accordance with section 546(b)(2)).

²⁸ See *In re Northeast Glass, Inc.*, 112 B.R. 475, 477 (Bankr. D. Mass. 1990) (holding that section 362(a)(6) “should not be construed to enjoin creditors from proceeding against nondebtor entities-such as guarantors, sureties, joint tort-feasors, co-obligors-who are liable with the debtor on the creditors’ claims”

from collection efforts. This may occur if action against a non-debtor would adversely affect the debtor's estate or interfere with the debtor's efforts to reorganize.²⁹

The Absolute Priority Rule

The absolute priority rule is an orderly waterfall prescribed by the Bankruptcy Code to ensure that senior creditors are paid in full before junior creditors and equity holders receive any recovery. Once a lien is perfected, the (sub)contractor who perfects becomes a senior secured creditor (as opposed to a junior or unsecured creditor), with a security interest in the underlying property equal to the value of its claim. In accordance with the absolute priority rule, the secured creditor is protected up to the value of the collateral securing its lien, which ensures proper payment.³⁰ As a secured creditor, a lienor is guaranteed to get the value of its claim out of the property, before any value of the property is available for distribution to junior creditors. The secured creditor is not obligated to split its distribution with junior creditors.

In many instances, a bank lender may also have a lien on a debtor's real property. Most states provide that the lien on a mechanic or materialman is senior to that of a pre-existing lender, thus giving mechanics and materialmen significant protection.

Adequate Protection

A secured creditor may be entitled to adequate protection pursuant to Section 361 of the Bankruptcy Code if its collateral is being used by the debtor during the bankruptcy case, in order to protect against any diminution in value caused by the secured creditor's inability to recover the property on which it has a lien.³¹ The Bankruptcy Code provides that adequate protection

²⁹ See, e.g., *Thompson v. Air Power, Inc.*, 448 S.E.2d 598, 603-604 (Va. 1994) analyzing *In re Richardson Builders, Inc.* 123 B.R. 736 (Bankr. W. D. Va. 1990) (regarding a subcontractors efforts to enforce a lien against the property which the debtor-general contractor did not own was stayed because the non-debtor owner was a necessary party).

³⁰ See 11 U.S.C. §§ 1129, 507.

³¹ See 11 U.S.C. §§ 361, 363, 364. The adequate protection doctrine protects secured creditors from losing their security as a result of the automatic stay.

may be provided by (1) requiring the trustee to make a cash payment or periodic cash payments ... (2) providing such entity an additional or replacement lien to the extent such stay, use, sale, lease or grant results in a decrease in the value of such entity's interest in such property, or (3) providing the indubitable equivalent or such entity's interest in such property. What constitutes adequate protection and the extent to which a creditor is entitled to it is a fluid concept, depending on the facts and circumstances of the case and the nature of the collateral at issue.

Bonds

There are four types of bonds typically used in the construction industry.³² These include (i) payment bonds³³ (ii) performance bonds;³⁴ (iii) bid bonds,³⁵ and (iv) subcontractor bonds.³⁶ For the purposes of this article, 'payment bonds' and 'performance bonds'³⁷ are the most relevant. Payment bonds provide protection similar to mechanic's liens in that they protect downstream³⁸ parties to a construction project against the bankruptcy or non-payment of an upstream party.³⁹ A performance bond is a surety⁴⁰ bond issued by an insurance company or

³² See *Ponoroff* at 352.

³³ Payment bonds protect both owners and subcontractors in the event that construction funds are diverted by the general contractor.

³⁴ Performance bonds provide insurance that the contractor will properly perform in a timely manner.

³⁵ Bid bonds protect an owner if the successful bidder on a construction project refuses to enter into a contract.

³⁶ Subcontractor bonds protect the general contractor against misappropriation of funds by a subcontractor.

³⁷ Performance bonds may cover (i) the cost of completing the work, (ii) defective and/or deteriorated work, (iii) delay and liquidated damages, (iv) consequential damages and (v) claims by others. While outside the scope of this article, there are nuances to what a performance bond covers. For more detail see Robert F. Cushman & James J. Meyers, *Construction Law Handbook* § 36 (1999).

³⁸ Please note that at certain points throughout this article, reference will be made to 'upstream' parties and 'downstream' parties. An 'upstream' party is any party in the bankruptcy context that makes payment to another party. A 'downstream' party is any party that receives payment. Therefore owners will be considered 'upstream' party and subcontractors generally a 'downstream' parties (unless the subcontractor subcontracts some of its work). But, a general contractor may be considered an 'upstream' or 'downstream' party depending on the context of the situation.

³⁹ Traditionally, mechanic's liens are not available as a remedy under government-owned construction projects. This is because public land (whether federally or state-owned) is not subject to seizure and thus a lien would be ineffective.

bank to guarantee satisfactory completion of the project. Payment bonds on a private construction project serve as additional protection to a supplier, contractor or subcontractor (in addition to the protections that mechanic's liens provide). Bonds on private projects are covered by the contract-terms of the bond and are enforceable under applicable contract law.⁴¹ Certain states have enacted regulations governing payment bonds for private projects.⁴²

Public Bonds: Miller Act⁴³

A construction project commissioned by the federal government requires a payment and performance bond, pursuant to the Miller Act.⁴⁴ Many states have enacted statutes similar to the Miller Act, which are commonly referred to as "Little Miller Acts,"⁴⁵ and provide protection for state and/or municipality commissioned construction projects. The Miller Act generally requires that the successful bidder on a government construction project provide a payment bond to protect subcontractors and suppliers from non-payment⁴⁶ and a performance bond to secure the government if the contractor is unable to complete the project.⁴⁷

Bonds and Bankruptcy

⁴⁰ "Surety – One who at the request of another, and for the purpose of securing to him a benefit, becomes responsible for the performance by the latter of some act in favor of a third person, or hypothecates property as security therefore." *Deluxe Blacks Law Dictionary* at p. 1441 (6th Edition).

⁴¹ See *Construction Law Handbook* at § 36.02.

⁴² For example, under Colorado law, a bond may be used to prevent the filing of a lien. The Colorado statutes that allow a party who supplies labor or materials to be placed a lien on the improved property does not apply where the principal contractor and his surety execute a performance bond and a labor and materials bond, each in excess of 150% of the contract price. Parties who would otherwise be entitled to file a lien may pursue the contractor and his surety directly, but must file suit within six months of completion of the project. Colo. Rev. Stat. § 38-22-129.

⁴³ Under the Miller Act, payment bonds generally cover labor and material used in the prosecution of the work. State bonds and private common law bonds may cover claims for labor and wages. See *Construction Law Handbook* § 36.04 (1999) for a more detailed analysis.

⁴⁴ See 40 U.S.C. §§ 3131-3134.

⁴⁵ For example, under Virginia law, the Virginia legislature adopted the "Little Miller Act" modeled after its federal counterpart. While many states do have "Little Miller" Acts, some states have different bond type statutes, and thus, it is important to review the law of the state where the property is located.

⁴⁶ See 40 U.S.C. § 3131(a)(2).

⁴⁷ *Id.*

A bond can be an alternative source of recovery for a non-debtor entity who has not received payment for work performed or supplies provided.⁴⁸ Certain payment bonds provide language that give a subcontractor the right to recover. The terms of the bond must be scrutinized to determine if subcontractors and suppliers qualify as intended beneficiaries. In addition, it must be determined if non-payment is attributable to the conditions provided for under the bond. In the case of a public project, a protected party must abide by the terms of the Miller Act (or “Little Miller” Act as the case may be).⁴⁹

Trusts

A trust is a legal entity that holds title to property (such as money) for the benefit others. Property held in trust is not considered part of the bankruptcy estate, and thus, is not available for distribution in accordance with the absolute priority waterfall. The bankruptcy estate comprises almost all property of the debtor upon filing for bankruptcy.⁵⁰ A subcontractor, supplier or other downstream party in a contractor’s bankruptcy would benefit from the money owed to the subcontractor, supplier or downstream party being considered to be held in trust for their benefit. Through the trust designation, the downstream party can avoid having its money become part of the bankruptcy estate. The determination of whether or not a trust (whether statutory, express or constructive) exists is critical in order to determine whether or not a downstream party gets paid from property not included in a debtor’s estate.

Statutory Trusts⁵¹

Certain states have enacted statutory trusts in favor of subcontractors when an upstream party is holding payment.⁵² There are significant policy rationales behind trust fund statutes,

⁴⁸ See 11 U.S.C. § 362(a)(6).

⁴⁹ See generally 40 U.S.C. §§ 3131-3134.

⁵⁰ See 11 U.S.C. § 541.

⁵¹ See, e.g., Mich. Comp. Laws. Ann. § 570.151, N.J. Stat. Ann §§ 2A: 44-148.

such as (i) the avoidance of encumbrances (in the form of liens) on properties, (ii) risk allocation and (iii) the negative effects on downstream parties in a bankruptcy.⁵³ Bankruptcy courts are expected to recognize the property rights created by applicable state statutes and enforce them in bankruptcy.⁵⁴ Because trust funds are not property of the estate, a trustee (or debtor-in-possession) will not be able to appropriate the trust and distribute those funds to other creditors,^{55,56} and a debtor's secured lenders will not be able to include those funds in either their pre- or post-petition collateral pools.

Express Trusts

An express trust is a trust which is created by document (contract). Although the concept is the same, an express trust is different than a statutory trust because money is held for the benefit of a subcontractor contractually and is subject to the terms of the construction contract.⁵⁷ Typically, the construction contract will have language that states that the general contractor will hold, for the benefit of the subcontractor, payments received by the owner/developer (or any

⁵² See *Selby v. Ford Motor Co.*, 590 F.2d 642 (6th Cir. 1979). (In an action to recover allegedly preferential transfers made by the bankrupt within four months of bankruptcy, the court held that under the Michigan Builders Trust Fund Act, the funds were not the "property" of the estate and therefore, the trustee in bankruptcy had no right to appropriate the funds for the benefit of general creditors. The court further noted that "the nature of the [construction] industry is such that commercial expectations of the parties are defeated when a building contractor or subcontractor does not use accounts paid to him on a job to pay subcontractors or materialmen.") *Id.* at 647.

⁵³ "[A Statutory trusts] justification is that the contractor, subcontractor and materialmen cannot spread their risks in the same way as the grocer or other merchants with many customers. Large quantities of labor and materials may go into a single construction project over a long period of time. A large part of a tradesman's capital may be tied up in a small number of construction projects. There is a substantial risk that a general contractor who goes bankrupt will pull down with him some of his subcontractors and materialmen, as well as cause serious economic loss to the owner." *Selby* at 647. See also *In re N.A. Flash Foundation Inc.*, 298 Fed.Appx. 355 (5th Cir. 2008).

⁵⁴ See *supra* at p. 5.

⁵⁵ *Selby* at 648.

⁵⁶ Note that while the statutory trust concept can be a powerful tool for a subcontractor in the bankruptcy of an upstream party, there are limitations. For example, certain courts have held that for a statutory trust to be effective, the downstream party must be in privity with the upstream party. In addition, certain of these trust statutes may not apply to public works projects (as they are covered by bond statutes such as the Miller Act). See *infra*.

⁵⁷ See Kent W. Collier, *The Nuts and Bolts of Bankruptcy, Trust Funds, and the Construction Industry: Building a Solution for Subcontractors "Nailed" with an Unpaid Bill*, 21 Emory Bankr. Dev. J. 623, 637-655 (2005).

other appropriate upstream party).⁵⁸ Case law developed in most states requires that property held in trust be held in a segregated account, and that access to such account be limited to certification that the conditions to its release have been met. It is not uncommon, however, for a contractor to neglect to set up the segregated account, and commingle the trust funds with its general funds. In that event, the trust character is destroyed (unless the creditor can argue for the imposition of a constructive trust), and the property becomes generally available to creditors, and the subcontractor or supplier is left with a general unsecured claim for breach of trust.

Constructive Trusts

A constructive trust is the only available trust remedy for a downstream party that is not in a jurisdiction with a statutorily provided trust nor had the foresight to negotiate an express trust. Constructive trusts are judicially-created. When the facts and equities of a situation require, a court may determine that funds held by a debtor should actually be owned by another. A constructive trust makes funds available to a downstream party outside the scope of the bankrupts estate. Thus, a subcontractor is allowed to recover outside of a general creditor distribution.⁵⁹ Certain states recognize the concept of a constructive trust for the benefit of a subcontractor.⁶⁰ Certain states recognize constructive trusts and certain states do not, therefore, it is vital to review the local law when determining possible ways to recover.

Preferences⁶¹

One of the most troubling bankruptcy aspects for a contractor is the fear that payments received within ninety days of the payor's bankruptcy filing (or one year if the payee was an

⁵⁸ In order to be sure that an express trust is created, the subcontractor should review the general trust creation rules of the jurisdiction in which the project is taking place in order to make sure that the requirements have been met.

⁵⁹ *Id* at 648.

⁶⁰ For example, Georgia has provided for the existence of constructive trusts. *See United Parcel Serv., Inc. v. Weben Indus., Inc.*, 794 F.2d 1005 (5th Cir. 1986), but Arkansas and Mississippi law does not support the existence of a constructive trust concept. *See Georgia Pac. Corp. v. Sigma Serv. Corp.*, 712 F.2d 962 (5th Cir. 1983).

⁶¹ See generally *Defenses to Preference Actions in Bankruptcy*, Construction Law Journal (Winter 2004, Vol. 2, Num. 2).

insider⁶²) will be avoided as preferential.⁶³ Preference law serves two main goals: (i) to foster equal distribution of funds between creditors and (ii) to disincentivize creditors from going after a financially shaky debtor in the ninety days prior to filing.⁶⁴ In order for such payments to be avoided, the trustee of the debtor must demonstrate certain elements, including that (i) the transfer was property of the estate and (ii) the transferee would not have received as much in a chapter 7 liquidation bankruptcy case.⁶⁵ Furthermore, the Bankruptcy Code provides transferees of otherwise avoidable transfers with certain defenses to defeat a trustee's or debtor's preference attack,"⁶⁶ including that the transfer was made in the ordinary course of business between the parties and in accordance with ordinary business terms or that the transfer was a contemporaneous exchange for new value.

Money Transferred was not Property of the Estate

One way to defeat a preference action is to show that the payments received were not property of the estate.⁶⁷ "A payment by a contractor-debtor to a subcontractor for materials or labor provided on a construction project may not be an avoidable preference because, if proven,

⁶² The term insider includes – (B) if the debtor is a corporation – (i) director of the debtor; (ii) officer of the debtor, (iii) general partner of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, or person in control of the debtor. *See* 11 U.S.C. § 101(31).

⁶³ Preference law is a wide and varied topic, which has many nuances. For the purposes of this article we will focus on one defense to a preference claim which incorporates the existence of mechanic's liens as they are prevalent in the construction context.

⁶⁴ Ben L. Aderholt, Henry J. Kaim, Christopher Von Driberg and Patrick Y. Lee, *Construction Contractors Defenses to Preference Actions in Bankruptcy*, *Construction Law Journal* at p. 11 (Winter 2004, Vol. 2, Num. 2)

⁶⁵ *See* 11 U.S.C. § 547(b). The transfer must be of an interest of the debtor in property "(1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made on or within 90 days before the date of the filing of the petition (or within one year if an insider); and (5) that enables such creditor to receive more than such creditor would receive if (A) the case were a case under chapter 7, (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title."

⁶⁶ *See also* 11 U.S.C. § 547(c).

⁶⁷ As a threshold matter, to be a preference, the debtor must have transferred "an interest of the debtor in property." *See* 11 U.S.C. § 547(b).

the payment may represent trust funds in which the debtor did not have a property interest.”⁶⁸ Since, as discussed above, the trust (whether statutory, express or constructive) does not allow the property to become part of the estate, it cannot be a preference to have received such funds regardless of when such funds were received.

⁶⁸ See *Construction Contractors Defenses to Preference Actions in Bankruptcy* at p. 7. See also *Selby* at 649. By analogy, the U.S. Supreme Court has determined that Internal Revenue Code trust provisions will exclude property from the bankruptcy estate. See *Begier v. I.R.S.*, 496 U.S. 53 (1990).

The Transferee Received No More Than They Would Have Received in a Chapter 7 Liquidation

A debtor may not avoid a transfer if the transferee received no more than it would have been entitled to receive in a chapter 7 liquidation case. Since generally, a secured creditor is entitled to receive the value of its collateral, payments to a secured creditor are not usually preferential. The anomalous situation that arises in construction cases is when a subcontractor or supplier would have been entitled to file a lien, thus making it a secured creditor, but did not actually file the lien, because it got paid. When bankruptcy ensues, the creditor gets sued for recovery of a preference on the basis that it would have been a general unsecured creditor.

Several Courts have considered the issue. In *Cimmaron Oil Co. v. Cameron Consultants*,⁶⁹ the debtor (Cimmaron) brought an adversary proceeding against the contractor creditor (Cameron) in order to recover purported preferential transfers. Cameron provided a variety of field services to two wells operated by Cimmaron. On March 31, 1981, Cimmaron paid Cameron via check in the amount of \$7,548.20 and on April 2, 1981, Cimmaron paid Cameron via check in the amount of \$1,325.00.⁷⁰ Both checks cleared. On July 10, 1981 Cimmaron filed for bankruptcy.⁷¹ The payments were made within 90 days of filing for bankruptcy and Cimmaron was presumed to be insolvent during the relevant period.⁷² Cameron did not take any affirmative action to perfect liens against Cimmaron prior to receiving payment, but the perfection period had not expired. In February of 1985, the preference action was brought against Cameron.

⁶⁹ 71 B.R. 1005 (N.D. Tex. 1987)

⁷⁰ *Id.* at 1006.

⁷¹ *Id.* at 1007.

⁷² *Id.* at 1007.

In ruling in favor of the contractor, the Court made a few salient statements. For example the Court stated: “[t]he essence of a preference is that it depletes or diminishes the estate of the bankrupt that is available for distribution to other creditors.”⁷³ The Court also explained that:

[a] transfer of property does not constitute a preference, however, unless the transfer enables a creditor to receive more than such creditor would receive under a chapter 7 case, the transfer had not been made, and the creditor received payment of such debt to the extent provided by the provisions of Section 547(b). Section 547(c)(b) as interpreted by the Court today, does not permit the lien creditor to obtain from the debtor any greater interest than the creditor would otherwise have realized.⁷⁴

Thus, the Court held that there was no preference because Cameron was in no better position than it would have been under a chapter 7 case because had it not been paid, it would have been entitled to file its lien.⁷⁵

Contemporaneous Exchange For New Value

A debtor may not avoid a transfer as preferential to the extent the transfer was (A) intended by the debtor and creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value⁷⁶ given to the debtor; and (B) in fact, was a substantially contemporaneous exchange.⁷⁷ New value may include the release of a mechanic’s lien against the debtor. New value may also include the release of a mechanic’s lien against a third party. The mechanic’s lien must be against collateral held by the debtor on which the lien

⁷³ *Id.* at 1011, citing *Thomas v. Gulfway Shopping Center, Inc.*, 320, F.Supp. 756, 762 (S.D.Tex.1970).

⁷⁴ *Id.* at 1011, citing *In re Johnson*, 25 B.R. 889, 893-894 (Bankr. E.D. Tenn 1982).

⁷⁵ While this argument has had some success, not all courts are in agreement. At least one court has explained that a creditor must take some action to enforce its mechanic’s lien in order to take advantage of this nuance of preference law. See *In re Globe Mfg. Corp.*, 567 F.3d 1291 (11th Cir. 2009) Other courts have also declined to follow this holding. See *In re J.A. Jones, Inc.*, 361 B.R. 94 (Bankr. W.D.N.C. 2007). Thus, as always it is important to review the law of the jurisdiction in which the construction project and the bankruptcy take place.

⁷⁶ “New value” means money or money’s worth in goods, services, or new credit, or the release by a transferee of property previously transferred in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation. 11 U.S.C. § 547(a)(2).

⁷⁷ See 11 U.S.C. § 547(c)(1).

would have value.⁷⁸ Thus, if the collateral already contained liens equal to or in excess of the value of the collateral, then no new value is created by the release of the mechanic's lien. As noted above, once a lien is recorded, the lienor becomes a secured creditor and the value of the lien is no longer available to general unsecured creditors.⁷⁹ Also, the payment from a debtor to a creditor with a mechanic's lien does not deplete the estate because the funds paid to the lienor would not have been available to general unsecured creditors.

Selected Current Topics

Products Liability: Chinese Drywall

A current issue in construction bankruptcies relates to "Chinese drywall," drywall manufactured in China by several multi-national companies. Some Chinese drywall used in the walls and ceilings of newly constructed houses from 2004-2007 is emitting a sulfur-like or rotten egg odor, causing corrosion of electrical coils (including in air-conditioners) and causing possible respiratory and/or other health issues.⁸⁰ Thousands of residents of newly-constructed homes have reported Chinese drywall problems. An estimated 100,000 houses throughout the country, mostly built in 2006 and 2007 are affected. It is believed that 500 million pounds of Chinese drywall, also known as plasterboard or gypsum board, entered the United States during 2006-2007.⁸¹ Chinese drywall is currently under investigation by the Environmental Protection Agency, the U.S. Consumer Product Safety Commission and the Center for Disease Control and Prevention.⁸² Most complaints are coming from Florida and Louisiana, but cases are also being

⁷⁸ See *Construction Contractors Defenses to Preference Actions in Bankruptcy* at p. 11.

⁷⁹ *Id.*

⁸⁰ M.P. McQueen, *The Prisoners of Drywall*, Wall Street Journal, August 6, 2009. Drywall is a gypsum product manufactured by a multitude of companies. Chinese drywall refers to drywall manufactured in China from gypsum mined from certain Chinese mines. The problems appear to be unique to drywall manufactured in China.

⁸¹ *Id.*

⁸² *Id.*

reported in other states throughout the United States.⁸³ In order to correct the problem, many homeowners are turning to lawsuits against home builders and Chinese drywall distributors. It is estimated that the average cost of replacing the Chinese drywall will be \$100,000 per home.

As noted above,⁸⁴ WCI Communities, Inc. (“WCI”) recently filed for chapter 11 protection. WCI has estimated that it will face up to \$40 million in Chinese drywall-related claims. On March 10, 2009, a lawsuit was filed in the U.S. District for the Southern District of Florida⁸⁵ against WCI (and certain Chinese drywall manufacturers) on behalf of all persons and businesses in Florida who purchased homes built or developed by WCI that contain Chinese drywall.⁸⁶ The filing of this lawsuit was a violation of the automatic stay and subsequently withdrawn, without prejudice by the plaintiffs.⁸⁷ On or about May 4, 2009, another purported class action was filed against a variety of Chinese drywall manufacturers. The plaintiffs stated that, but for the pendency of the chapter 11 case, WCI would have been included in the suit.⁸⁸ Subsequently, these plaintiffs filed, in the Bankruptcy Court, a motion for leave to file a class proof of claim and to certify as a class all owners and residents of residential homes built by WCI that contain Chinese drywall.⁸⁹ WCI has objected, and the matter is currently pending.

As a result of the Chinese drywall product-liability related issues, WCI has proposed to set up a trust known as the “Chinese Drywall Trust.”⁹⁰ WCI has proposed to fund the trust with \$900,000 for administration fees/expenses and preferred stock (equity) in post-bankruptcy new

⁸³ *Id.*

⁸⁴ *Supra* at 1.

⁸⁵ *See* Case No. 09-CV-60371.

⁸⁶ *Second Amended Disclosure Statement Relating to the Second Amended Joint Chapter 11 Plan of Reorganization for WCI Communities, Inc. and its Affiliated Debtors* at 50, *In re WCI Communities, Inc.*, Case No. 08-11643 (KJC) (D. Del. 2008).

⁸⁷ *Id.* at 50.

⁸⁸ *Id.* at 51.

⁸⁹ *Id.* at 51.

⁹⁰ *Id.* at 76.

WCI.⁹¹ The purpose of the Chinese Drywall Trust will be to, among other things, resolve all Chinese drywall claims and bring lawsuits that might have been pursued by WCI in order to help pay for homeowner damages.⁹² The Chinese Drywall Trust will, upon the effective date of a plan of reorganization, assume all responsibility and liability for all Chinese drywall claims. The Chinese Drywall Trust will have no recourse against the post-bankruptcy WCI entity.⁹³

Product liability issues, such as the Chinese drywall problems discussed above, can have a major impact on a construction company in and out of bankruptcy. It is important for all parties to a construction project to understand the ramifications of such product liability issues and to follow the progress of the debtor in dealing with these issues to be aware of their rights as upstream or downstream parties. The resolution of mass tort cases in bankruptcy is a well-developed field as a result of significant jurisprudence developed over the last 30 years in the litigation of asbestos cases. However, when the Bankruptcy Code was amended in 1994, the amendment dealing with mass torts only dealt with asbestos cases, not other types of mass torts. Debtors and Courts are likely to adopt parts of the trust fund structure of Section 524(g) of the Bankruptcy Code in dealing with Chinese drywall liabilities.

Financing

Most construction projects are financed. Debt structures were far less complex in the early 1990s, with fewer tranches, or tiers of segregated capital. Today, untangling the many and often-conflicting stakeholders' interests make asset disposition a longer and more drawn-out process. Parties frequently wind up in court.

In the recent real estate and construction boom, the structures of these project finance transactions have become more complex and multi-layered. While a complete description of

⁹¹ *Id.* at 76.

⁹² *Id.* at 76-78.

⁹³ *Id.* at 79.

construction finance is beyond the scope of this article, generally, a construction project is financed by a group of lenders who distribute funds to the project manager or builder as construction progresses in accordance with certain milestones set out in the credit agreement and related documents. Funds can only be drawn from the credit facility in accordance with the credit agreement's provisions, and can only be utilized for the purposes set out in the credit agreement. The lenders take a first lien on the property, and often require that they be taken out by a different group of lenders or by a new facility after the project is complete. Construction finance often includes multi-tranche and multi-tiered lien structures. Each structure is unique to its project.

A commercial real estate venture's capital structure is a sophisticated pecking order of junior and senior debtholders. At the top of the capital structure are first mortgages, usually held by senior lenders. Next come mezzanine loans, which are in effect second mortgages secured by a second lien on the first lienholders' collateral as well as the borrower's stock or equity. The owner's equity in the project comes third in the financial hierarchy.

Mezzanine loans are senior to the property owner's equity interests, but are subordinate to whole mortgage loans secured by first or second mortgage liens. In the event of a default, however, mezzanine lenders have the power to foreclose on the property, pay off the first mortgage and take ownership of the property. In addition, modern securitized commercial loans are bifurcated by risk, with B-rated mortgage notes subordinate to A-rated notes. In today's economy, disputes between builders and lenders and disputes between lenders and lenders have become common. Some of the most recent disputes and issues are summarized below.

Fontainebleau Las Vegas LLC

The Fontainebleau case deals with a situation where the lenders refused to continue to fund. On June 9, 2009 Fontainebleau Las Vegas LLC (“Fontainebleau”) voluntarily filed for chapter 11 protection in the Southern District of Florida. The Fontainebleau is a \$2.9 billion construction project in Las Vegas in which construction has ground to a halt as a result of Citigroup (and other lenders) refusing to continue to fund or refinance the senior secured loan.

Fontainebleau was operating under a \$1.85 billion senior secured credit facility made up of a \$700 million term loan, a \$350 million delay draw term loan facility and an \$800 million revolving credit facility.⁹⁴ The senior secured credit facility is secured by a first priority lien on substantially all of the assets of the Fontainebleau project.⁹⁵ There were also \$675 million of 10.25% Second Mortgage Notes Due 2015 (the “Notes”) issued. The Notes are secured primarily by a mortgage lien on the project.⁹⁶ In addition, a \$315 million construction loan was entered into with Lehman Brothers Holdings, Inc. (“Lehman”) (which portions of the loan were syndicated).⁹⁷

Because of Lehman’s bankruptcy filing on September 15, 2008, Lehman failed to make advances under the construction loan.⁹⁸ As result of (i) the Lehman bankruptcy filing, (ii) the insolvency of one of the lenders under the delayed draw term loan, (iii) the global decline in the credit markets, (iv) the general decline in tourism and the Las Vegas economy and (v) the defaults and termination of members of the senior credit facility, Fontainebleau was forced to file for bankruptcy.⁹⁹ To this point Fontainebleau has been unable to find new sources of financing

⁹⁴ *In re Fontainebleau Las Vegas Holdings, LLC*, Case No. 09-21481-BKC-AJC (jointly administered), United States Bankruptcy Court, Southern District of Florida, Docket No. 5, at p. 6.

⁹⁵ *Id.*

⁹⁶ *Id.* at p. 7.

⁹⁷ *Id.* at p. 8.

⁹⁸ *Id.* at p. 9.

⁹⁹ *Id.* at 8-10.

and as a result, most materialmen have left the jobsite and filed mechanic's liens against the project.¹⁰⁰ Prior to the bankruptcy filing, the Fontainebleau filed a \$3 billion lawsuit in Nevada State Court against Bank of America and other lenders who declined to provide funding under the senior secured credit facility. The lawsuit was voluntarily dismissed by Fontainebleau after it filed for bankruptcy, and then refiled in the Bankruptcy Court in Miami where Fontainebleau's case is pending.

Bank of America and other lenders under the senior secured credit facility claim to have cut off funding because the Fontainebleau "[v]iolated a technical provision in the credit agreement governing the order in which funds would be provided and under what conditions. Later, the banks have said, they determined Fontainebleau was in default of the credit agreement and insolvent because of cost overruns and other problems."¹⁰¹ Fontainebleau claims that it was not in default and even if it were, this did not give the banks the right to cut off funding.¹⁰²

The lenders successfully had the case removed to the District Court in Miami. Fontainebleau filed a motion for summary judgment, asking the District Court to order the release of \$656 million in funding needed to restart the project.¹⁰³ On August 26, 2009, Fontainebleau's motion to for summary judgment was denied, with the Court finding that the lenders' interpretation of the credit agreement was correct as a matter of law.

The result in the Fontainebleau case is becoming increasingly likely in today's economic environment. It will not be uncommon to see construction lenders refusing to lend based on real or 'creative' defaults under the relevant credit documents. It is important to note the impact not only on the project, but on the surrounding community. Approximately 6,000 employees will

¹⁰⁰ *Id.* at 10.

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ Steve Green, *Fontainebleau fires back, outlines bank dispute*, Las Vegas Sun (July 8, 2009)

need to find jobs elsewhere as a result of the Fontainebleau work stoppage.¹⁰⁴ This case is merely one example of a trend occurring in the global construction community.

Debt Acquisitions and Inter-Lender Disputes

Battles between junior and senior players in the commercial property mortgage capital stack are heating up as lenders try to avoid having their investments wiped out by the wave of troubled loans reaching maturities. Mezzanine debt holders have been particularly active of late, exercising their option to push overleveraged owners -- including many who purchased property at inflated prices at the height of the market two or three years ago -- into foreclosure in order to gain control of the property.¹⁰⁵

In March 2009, mezzanine lenders took over Boston's John Hancock Tower and an office tower in Los Angeles after gradually acquiring discounted tranches of the debt over the previous year. In August 2009, Citigroup seized the luxury 400-room St. Regis Monarch Beach Resort in Dana Point, CA, after the owners defaulted on a \$70 million mezzanine loan. Citigroup scrapped a foreclosure auction after it became clear there would be no serious bidders.

The pricing of first and second lien debt has also made it attractive to third-party investors. Acquisition of mezzanine debt followed by foreclosure has become a standard vulture play in recent months. Investors typically acquire a senior piece of the mezzanine debt on a distressed property at a deep discount. When the borrower fails to make payments, the new lenders take the property into foreclosure, often buying the asset for pennies on the dollar at auction. A new deal can be cut with the first lenders or refinanced. Such foreclosures are

¹⁰⁴Terry Goodwin, *Fontainebleau Bankruptcy Deals Blow To Las Vegas Casino Industry*, CasinoGamblingWeb.com (June 11, 2009).

¹⁰⁵ Randy Drummer, *Tranche Warfare: Mezzanine Lenders Stepping Into Foreclosure Fray*, CoStar Advisor Newsletter, Sept. 2, 2009.

occurring across the real estate spectrum, from office, hotel, retail, condominium and mixed-use properties to development land.

Purchaser Contracts

When the real estate market was hot, condo developers were able to pre-sell most of their units, even before construction was complete. In some cases, buyers put up 20% of the sales price under so-called accommodation agreements under which the developer had the right to sell the property at a higher price if the market improved and the buyer was given certain rights, including the right to terminate the purchase contract after a certain period of time. Section 365 of the Bankruptcy Code gives a debtor the right to assume all executory contracts that benefit it and reject those that do not. In developer insolvency cases, the developer wants to assume any pre-existing purchase contracts, thereby compelling a buyer to buy the pre-sold unit, but not any related accommodation agreement, thereby eliminating the additional rights given the buyer and additional obligations put on the seller.

This strategy backfired in the case of Ecoventure Wiggins Pass, Ltd.¹⁰⁶ Ecoventure is the developer and owner of a luxury waterfront condominium development in Naples, Florida. Its bankruptcy was precipitated by the downturn in the Florida real estate market and by the refusal of its lenders to continue to fund the additional draws necessary for the completion of the project. Ecoventure filed bankruptcy soon after its lenders commenced a foreclosure action in Florida state court. At the time of the bankruptcy filing, the project was about 95% completed.

Ecoventure had been successful in pre-selling a substantial number of its units before the real estate market crashed. The standard form purchase contract was executed contemporaneously with an accommodation agreement that required a buyer to make a 20%

¹⁰⁶ *Ecoventure Wiggins Pass, Ltd.*, Case No. 9:08-bk-9198-ALP, United States Bankruptcy Court for the Middle District of Florida.

downpayment, which Ecoventure could use for development costs. As required by the project lenders, the agreement also provided that the developer would continue to market the pre-sold unit and could sell it to another buyer for the same or a better price. In exchange for these accommodations, the buyer was permitted to cancel the contract any time after one year, and receive interest on its deposit.

When Ecoventure filed for bankruptcy, it reached accommodation with its existing lenders and a new lender to get the financing needed to complete the project. It then proceeded to file a plan of reorganization dependent upon assumption of all its purchase contracts, but not the related accommodation agreements. A number of the buyers, who had exercised their accommodation agreement termination rights shortly before the bankruptcy was filed (precipitated by the existence of the foreclosure action) objected to the assumption of their purchase agreements. The buyers argued that the purchase agreements had been terminated prior to the bankruptcy in accordance with the accommodation agreements, and therefore, could not be assumed. The buyers further argued that even if the terminations were not effective, the debtor could not assume one contract (the purchase agreement) without the other (the accommodation agreement) because the two agreements were really one contract.

In a series of opinions over the summer of 2009, the bankruptcy court agreed with the buyers. Under Florida law, which applied to the interpretation of the contracts, the purchase agreements and the accommodation agreements were to be construed as one contract. Therefore, the debtor could not assume the benefits of one without assuming the obligations of the other. Thus, in most instances, the contracts had been terminated prior to bankruptcy and the buyers could not be forced to complete the sales. This has thrown the debtor's plan proposal in disarray as it will now be required to sell its units at significantly reduced market prices in a slow

luxury market, thereby destroying the financial projections on which the plan proposal was based.

Conclusion

The current economic climate is one fraught with risk, especially in the construction industry. It is important to understand that there are many reasons why a party to a construction contract may not get paid for the services and materials provided. Fundamental to protection from the disaster of non-payment is an understanding of the laws and rules that govern. This article gives a sampling of the rights and privileges various parties to a construction project may have and highlights some of the recent issues and developments in construction industry insolvency cases.