

By John L. McCants

Addressing specific principles common in construction law, including insurance, surety, claims and arbitration.

Fundamentals for the Construction Law Practitioner

The Bankruptcy Code, codified as Title 11 of the United States Code, and the Federal Rules of Bankruptcy Procedure govern bankruptcy cases. In addition, the bankruptcy court that has jurisdiction of a particular case

will have local rules that are applicable to the case. The Bankruptcy Code has chapters, which set forth the principles that govern different kinds of debtors and debt relief. The chapters that the construction law practitioner may likely encounter are Chapters 11, 7 and 13.

Chapter 11

Chapter 11 is for the reorganization of a business, but may be available to an individual consumer. In a Chapter 11 case, the debtor operates the business much as the debtor did before filing for bankruptcy relief. 11 U.S.C. §1107. A trustee does not operate the business or control the assets, unless the court appoints a trustee. The court may appoint a trustee when there has been some fraud, gross mismanagement, or the like, by the debtor in the operation of the business during the Chapter 11 case. 11 U.S.C. §1104. (Note, however, that, in a Chapter 11 case, the Office of the United States Trustee (part of the United States Department of Justice) monitors the

case and has certain procedural and substantive rights.)

In a Chapter 11 case, the debtor files a “plan,” which addresses how the debtor intends to reorganize its debts and financial affairs. 11 U.S.C. §§1121, 1124. The plan is a legally binding document or new contract. 11 U.S.C. §1141(a). At the time the case is filed, the debtor is given a period to file its plan. Only the debtor may file a plan with the petition commencing a voluntary case. 11 U.S.C. §1121. Unless otherwise provided, only the debtor may file a plan until after 120 days after the filing the case. 11 U.S.C. §1121(b).

In a plan, a debtor may, among other things, reamortize a secured debt and modify interest rates to reflect current market conditions. 11 U.S.C. §1123; *In re Bryson Properties, XVIII*, 961 F.2d 496 (4th Cir. 1992). The court will hold a hearing on confirmation of a plan, at which time the court will hear objections to the plan and determine whether the plan complies with the Code. 11 U.S.C. §1129. A party in interest may object to the confirmation of the plan. 11 U.S.C. §1128. If the court confirms the plan, the confirmation discharges the debtor of certain debts, and establishes the new financial obligations of the debtor. 11 U.S.C. §1141.



■ John L. McCants is a shareholder with Ellis, Lawhorne & Sims, P.A., in Columbia, South Carolina. His practice focuses on construction and commercial law, including bankruptcy law. He is a past president of the Richland County Bar Association and the South Carolina Bankruptcy Law Association.

Chapter 7

Chapter 7 is a liquidation proceeding. In a Chapter 7 case, a trustee takes possession of the property of the debtor and sells nonexempt property to pay creditors. In general, the trustee will only sell those assets that may have equity over and above any liens on the property and that may realize a return for unsecured creditors. The proceeds

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realized from a sale of a property are used to pay creditors according to priorities established by the Code. 11 U.S.C. §726. If a trustee chooses not to sell a particular piece of property, the trustee may “abandon” the property to the debtor, subject to any liens or interests. There is no plan of reorganization in a Chapter 7 case. The primary benefit for the individual debtor filing Chapter 7 is a discharge of debts. 11 U.S.C. §727. A discharge generally prohibits creditors from taking action in the future to collect a debt from the debtor personally. 11 U.S.C. §524. A corporation does not receive a discharge of debts in a Chapter 7 case. 11 U.S.C. §727(a)(1). A secured creditor may enforce its *in rem* rights in collateral. See *Hawkins v. Landmark Finance Co.*, 727 F.2d 324 (4th Cir. 1984).

An individual debtor is granted a discharge by the court unless there is an objection to the discharge and denial of the discharge by the court—the grounds are set forth in 11 U.S.C. §523 and 11 U.S.C. §727. If a party believes there are grounds to challenge the discharge (or the discharge of a particular debt), the party may file an adversary proceeding, *infra*, to have the court determine the dischargeability of a specific debt; or to have the court determine whether the debtor is entitled to a general discharge.

Chapter 13

Chapter 13 is a reorganization proceeding. An individual doing business as a construction company may file Chapter 13 and operate his or her business. 11 U.S.C. §1304. The Code limits a Chapter 13 case to 1) individuals, 2) with unsecured debts of less than \$336,900.00 and secured debts of less than \$1,010,650.00. 11 U.S.C. §109(e). In a Chapter 13, the debtor shall file a plan. 11 U.S.C. §1321. The court will hold a hearing on confirmation of the plan. 11 U.S.C. §1324. The Chapter 13 debtor must have regular income to fund a plan. 11 U.S.C. §109(e). Otherwise, the debtor should seek Chapter 7 relief. A trustee administers the Chapter 13 case, including collecting plan payments from the debtor and distributing the payments to creditors. 11 U.S.C. §1302. The trustee, however, does not operate the debtor's business. See 11 U.S.C. §1304.

Commencement of a Bankruptcy Case and Property of the Estate

The voluntary filing of a petition under Title 11 commences a bankruptcy case. 11 U.S.C. §301. A certain number of creditors may also commence a bankruptcy case against a debtor (an involuntary case). See 11 U.S.C. §303. In an involuntary case, the debtor may contest the petition placing the debtor into bankruptcy before the bankruptcy court. 11 U.S.C. §303.

The commencement of a case creates an estate, which is comprised of “all legal or equitable interests of the debtor in property as of the commencement of the case.” 11 U.S.C. §541(a)(1). Federal courts broadly define the term “property.” See *In re Weiss*, 111 F.3d 1159 (4th Cir. 1997); *Tringali v. Hathaway Machinery Co., Inc.*, 796 F.2d 553 (1st Cir. 1986). The United States Supreme Court has stated, “[t]he House and Senate Reports on the Bankruptcy Code indicate that §541(a)(1)'s scope is broad.” *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204–05, 103 S. Ct. 2309, 2313 (1983). The legislative history to §541(a)(1) states:

The scope of this paragraph [§541(a)(1)] is broad. It includes all kinds of property, including tangible or intangible property, causes of action... and all other forms of property currently specified in §70a of the Bankruptcy Act.

United States v. Whiting Pools, Inc., 103 S. Ct. 2309, 2313.

Whether property is property of the estate may be an important issue for the construction law practitioner. For instance, insurance plays an important role in the construction industry, and the practitioner may need to know the effect of the bankruptcy filing on an insurance policy issued to a debtor. Property of the estate may include a liability insurance policy purchased by the debtor. *A.H. Robins Co. Inc. v. Piccinin*, 788 F.2d 994 (4th Cir. 1986), *cert. denied*, 479 U.S. 876, 107 S. Ct. 251, 93 L. Ed. 2d 177 (1986); *Tringali v. Hathaway Machinery Co., Inc.*, 796 F.2d 553, 560 (1st Cir. 1986). The United States Court of Appeals, Fourth Circuit stated:

A products liability policy of the debtor is similarly within the principle: it is a valuable property of a debtor, particularly if the debtor is confronted with substantial liability claims within the coverage of the policy in which case the policy may well be... “the most important asset of... [the] estate.”

A.H. Robins Co. v. Piccinin, 788 F.2d at 1001 (quoting *In re Johns Manville Corp.*, 40 B.R. 219, 229 (S.D.N.Y. 1984).

The conclusion that a liability insurance policy may be property of the estate may not preclude a claimant from pursuing the coverage or proceeds of the policy. See *Matter of Edgeworth*, 993 F.2d 51 (5th Cir. 1993). Whether a claimant can recover the proceeds of an insurance policy may be a particularly important issue if the insured debtor is insolvent. To illustrate, in *Matter of Edgeworth*, a medical doctor filed a Chapter 7 case and thereafter received a discharge. One of the debtor's patients requested relief from the discharge to pursue a medical malpractice action in state court against the insured debtor. The bankruptcy court approved the request but then reversed itself by enforcing the bankruptcy discharge, thereby enjoining the patient's lawsuit. The United States district court affirmed the decision.

The United States Court of Appeals, Fifth Circuit reversed the decision and granted leave to the patient to pursue the malpractice claim. The court of appeals held the debtor's liability insurance policy proceeds were not property of the estate. *Id.* at 54. The court reasoned the policy gave the insured debtor contractual rights against the insurer and those rights were property of

the estate. *Id.* at 54. However, the insurance proceeds were not property of the estate because proceeds under a typical liability policy benefit only persons to whom the insured is liable. *Id.* at 54. “The overriding question when determining whether insurance proceeds are property of the estate is whether the debtor would have a right to receive and keep those proceeds when the insurer paid on a claim.” *Id.* at 55.

The discharge of a debtor does not affect the liability of another entity liable for such debt. 11 U.S.C. §524(e). “Most courts have held that the scope of a §524(a) injunction does not affect the liability of liability insurers and does not prevent establishing their liability by proceeding against a discharged debtor.” *Id.* at 54. “Thus, as long as the costs of defense are borne by the insurer and there is no execution on judgment against the debtor personally, §524(a) will not bar a suit against the discharged debtor as the nominal defendant.” *Id.* at 54. The claimant may not pursue the discharged debtor personally; relief to the claimant will be limited to the insurance proceeds.

Pearlman v. Reliance Ins. Co., 371 U.S. 132, 83 S. Ct. 232 (1962), is a seminal bankruptcy law case regarding surety law. In *Pearlman*, which was decided prior to the enactment of the Bankruptcy Code, a contractor entered into a construction contract with the United States government. Reliance Insurance Co. executed a performance and payment bond as required by the Miller Act. Under the terms of the contract between the contractor and the government, the government held a retainage fund for a percentage of the work until completion. The fund would be turned over to the contractor upon completion of the project.

During the course of the construction, the contractor had financial problems and defaulted on the contract. The government and the contractor terminated the contract by agreement because of the default. The contractor then filed for bankruptcy relief, and another contractor completed the job. At the end of the job, there was approximately \$88,000.00 remaining in the retainage fund. Reliance paid \$350,000 to laborers and suppliers pursuant to the bonds to discharge the Debtor’s debts. The government turned over the approximately \$88,000.00 to the bankruptcy trustee.

Reliance filed an action alleging the fund

was its property. The Trustee maintained the fund was property of the bankruptcy estate. The bankruptcy court (a referee) held Reliance was a general creditor and had no superior right to the fund. The United States District Court vacated the bankruptcy referee’s order and held Reliance had priority to the fund. The United States Court of Appeal, Second Circuit affirmed the district court decision.

The United States Supreme Court granted certiorari and heard the appeal. The Supreme Court ruled in favor of Reliance. The Supreme Court stated, “...a surety who pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be reimbursed.” *Id.* at 235. This remedy is commonly known as the right of subrogation. *Id.* at 235. Further, the Court noted, “[o]wnership of property rights before bankruptcy is one thing; priority of distribution in bankruptcy of property that has passed unencumbered into a bankrupt’s estate is quite another.” *Id.* at 234. “...if the surety at the time of adjudication was, as it claimed, either the outright legal or equitable owner of this fund, or had an equitable lien or prior right to it, this property interest of the surety never became a part of the bankruptcy estate.” *Id.* at 234. A surety who completes a contract has an “equitable right” to indemnification out of a retained fund. *Id.* at 236.

The Supreme Court held that Reliance had a subrogation right to the fund when Reliance completed the Debtor’s contractual obligations of performance or payment. *Id.* at 237. The government had a right to use the fund to pay labor and material costs. The laborers and material suppliers had a right to be paid from the fund. The debtor had it paid the laborers and material suppliers, would have had a right to the fund. Because Reliance paid the laborers and material suppliers, Reliance had a superior right to the fund in the bankruptcy case. *Id.* at 237.

The facts in *Pearlman* may be analyzed differently under the Bankruptcy Code because of 11 U.S.C. §541(a)(1). However, the result in *Pearlman* may be the same under the Code based on 11 U.S.C. §541(d). §541(d) provides that, “[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest... becomes property of the

estate... only to the extent of the debtor’s legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.”

Automatic Stay

One of the fundamental benefits of the Bankruptcy Code to a debtor is the automatic stay. The commencement of a case operates as an automatic stay against various actions against the debtor. 11 U.S.C. §362 states in part:

- (a) Except as provided in subsection (b) of this section, a petition filed under §301, 302, or 303 of this title, or an application filed under §5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to an entities, of
 - (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
 - (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
 - (3) any act to obtain possession of property of the estate or to exercise control over property of the estate;
 - (4) any act to create, perfect, or enforce any lien against property of the estate;
 - (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
 - (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

- (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
- (8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

If it elects to assume the contract, the contractor may not assume the benefits of the contract and reject the burdens.

The breadth of the foregoing list is broad, and a claimant must be careful not to violate the automatic stay. When in doubt whether the stay should apply, it is likely more prudent to move before the bankruptcy court asking for relief from stay than it is to suffer sanctions or damages for violating the stay. A creditor may seek relief (by motion) from the automatic stay for (a) cause, including the lack of “adequate protection” of an interest in property of such party in interest; or (b) to the extent the debtor does not have equity in the property and the property is not necessary to an effective reorganization. There are also additional provisions contained in 11 U.S.C. §362(d).

The stay is limited to the debtor in bankruptcy, which is problematic for the owner of a construction company who has guaranteed the companies’ debts. Notwithstanding a Chapter 11 or Chapter 7 bankruptcy case, a creditor may continue to pursue collection against a non-filing debtor. The filing of the bankruptcy acts as an automatic stay against collection only in favor of the specific debtor. *A.H. Robins Co.*, 788 F.2d at 999. If an individual guarantor of a corporate debtor in bankruptcy has not filed bankruptcy, the individual guarantor does not receive the benefit of the stay against collection. A bankruptcy court, however, may extend the stay to a non-debtor if the stay protection is essential to reorganiza-

tion. *A.H. Robins Co.*, 788 F.2d at 994; *McCartney v. Integra National Bank North*, 106 F.3d 506 (3d Cir. 1997). Relief is sought under the broad enabling power in 11 U.S.C. §105. *A.H. Robins Co.*, 788 F.2d at 1002.

Executory Contracts

Assume a contractor is constructing a building for an owner, and the contractor files a Chapter 11 case. Must the owner continue in the contract with the contractor during the bankruptcy case? The answer may depend on whether the construction contract is executory. “A contract is executory if performance is due to some extent on both sides.” *Lubrizol Enter., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). The United States Court of Appeals, Fourth Circuit stated, “if obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other.” *Id.* at 1045.

Assuming there is an executory construction contract, the debtor contractor will have one of two options: 1) assume the contract (continue performing); or 2) reject the contract (walk away). 11 U.S.C. §365 governs the treatment of executory contracts entered into by the debtor prior to the filing of the bankruptcy petition. *In re Merry-Go-Round Enterprises, Inc.*, 180 F.3d 149 (4th Cir. 1999). The section provides:

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

- (A) cures, or provides adequate assurance that the trustee will promptly cure, such default;
- (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
- (C) provides adequate assurance of future performance under such contract or lease.

If the debtor contractor elects to assume the construction contract, it must comply with the foregoing section. Further, if it

elects to assume the contract, the contractor may not assume the benefits of the contract and reject the burdens. When a debtor assumes an executory contract, it assumes the contract *cum onere*—a debtor must accept the obligations of the executory contract along with the benefits. *U.S. Dept. of Air Force v. Carolina Parachute Corp.*, 907 F.2d 1469, 1472 (4th Cir. 1990).

If the debtor contractor elects to reject the executory construction contract, the debtor’s decision will be largely within its discretion. The debtor’s decision to reject an executory contract is accorded deference mandated by the business judgment rule as generally applied by courts to discretionary actions or decisions of corporate directors. *Lubrizol Enter. Inc.*, 756 F.2d at 1046 (4th Cir. 1985). Courts believe that the authority to reject an executory contract is vital to the basic purpose of Chapter 11 reorganization, because rejection can release the debtor’s estate from burdensome obligations that can impede a successful reorganization. *In re Shangra-La, Inc.*, 167 F.3d 843 (4th Cir. 1999).

Finally, the owner may not be able to walk away from the contract only because the contractor filed for bankruptcy relief. The general rule is that *ipso facto* clauses or a default-upon-filing clause violates public policy, so the non-filing party may not use the bankruptcy alone as an excuse to breach the contract. *Riggs Nat. Bank of Washington, D.C. v. Perry*, 729 F.2d 982 (4th Cir. 1984).

Claims

In addition to contract law, a state may recognize other legal principles in construction law litigation, such as negligence, express and implied warranties and Uniform Commercial Code remedies. Causes of action or claims based on these legal principles may constitute claims against a bankruptcy estate that may be addressed in a Chapter 7, 11 or 13 cases. The Bankruptcy Code defines the word “claim” to be (a) right to payment, whether or not such right is reduced to judgment, liquidated, or unliquidated, fixed, contingent, matured, disputed, undisputed, legal, equitable, secured, or unsecured; (b) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an

equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured. 11 U.S.C. §101(5).

The claims process is central to a bankruptcy case and revolves around the “proof of claim.” With some exceptions, a claimant must file a written “proof of claim” with the bankruptcy court to evidence its claim. BANKR. RULE 3001. The proof of claim document is a national legal form and is typically accessible on the United States Bankruptcy Court website for a particular jurisdiction. If the debtor has a dispute with a particular claim, a debtor may file a written objection to a proof of claim. BANKR. RULE 3007. Once an objection is filed, the court will schedule a hearing and adjudicate the claim. If an objection to a claim is joined with a demand for relief of the kind specified in BANKR. RULE 7001, the objection becomes an adversary proceeding. BANKR. RULE 3007.

An adversary proceeding is a civil lawsuit, arising out of or related to the bankruptcy case. Part VII of the Bankruptcy Rules governs these proceedings. Of note, in bankruptcy terminology, the word “case” means the underlying bankruptcy commenced pursuant to Title 11; the word “proceeding” generally refers to an adversary proceeding or other contested matters filed within the case. In an adversary proceeding, there is a summons/complaint, answer or motion(s) to the pleadings, other dispositive motions, discovery and a trial. With some limitations, the Federal Rules of Civil Procedure are applicable to an adversary proceeding.

A party may be entitled to a trial by jury in an adversary proceeding. 28 U.S.C. §1411; BANKR. RULE 9015. Whether one is entitled to a jury trial will depend on the nature of the claim. The debtor is not entitled to a jury trial for an equitable procedure under the Bankruptcy Code. See *Granfinanciera, S.A. v. Norberg*, 109 S. Ct. 2782, 492 U.S. 33 (1989). In *Granfinanciera, S.A. v. Norberg*, the United States Supreme Court held that a third party who had not filed a proof of claim in the bankruptcy case and who was being sued by the trustee pursuant to 11 U.S.C. §547 to recover a fraudulent conveyance was entitled to a jury trial. Although Congress had delineated a fraudulent conveyance action as a “core” one, the Supreme Court reasoned such an action was nevertheless a legal one at common law. Further, the defendant had not submitted itself to the equitable jurisdiction of the bankruptcy court by filing a proof of claim. *Granfinanciera*, 492 U.S. 33, 109 S. Ct. 2782. The bankruptcy court is a court of equity, and a party may submit to its jurisdiction with the filing of a proof of claim. *Granfinanciera*, 492 U.S. at 58, 109 S. Ct. at 2799. If the right to a jury trial is applicable, a party must consent to a bankruptcy judge conducting the jury trial. BANKR. RULE 9015(b).

Arbitration

It is common for a construction contract to include an arbitration clause. Arbitration is a favored forum under federal law. *Moses H. Cone Mem’l Hosp. v. Mercury Contr. Corp.*, 460 U.S. 1, 103 S. Ct. 927 (1983). Courts generally hold that an arbitration clause

can be enforceable in a bankruptcy case if the enforcement would not undermine the purposes of the Bankruptcy Code. See *Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1156 (3d Cir. 1989); *In re United States Lines, Inc.*, 197 F.3d 631 (2d Cir. 1999), *cert. denied*, 120 S. Ct. 1532 (2000). The decision whether to enforce an arbitration clause may depend on whether the matter is related to the bankruptcy case versus whether the matter arises directly out of the bankruptcy. A bankruptcy court may have the discretion in a “core” proceeding to override an arbitration clause. *In re United States Lines, Inc.*, 197 F.3d at 640. The reasoning for this discretion is that a bankruptcy court must be able to exercise complete jurisdiction over matters central or “core” to the bankruptcy case. *Id.* at 640.

Conclusion

The construction law practitioner may be involved in a bankruptcy case during his or her career. This statement is particularly true for 2008–09 because the residential construction industry in the United States experienced a significant downturn during this time. The first part of the article should give the reader a general overview of bankruptcy law and Chapters 11, 7 and 13 of the Bankruptcy Code. The second part of the article addresses specific principles common in construction law, including insurance, surety, claims and arbitration. The primary cases cited in the second part address how some courts apply bankruptcy law to these areas of construction law. 