

A breath of fresh air for construction trust fund creditors in the Bankruptcy Court¹

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In August of this year [Ed. Note: 2008], The United States Court of Appeals for the Fifth Circuit (the Federal Circuit which includes Texas) decided *Lowe v. Palmetco, Inc.*² holding that a trustee in bankruptcy can not avoid, as a preference, construction trust funds paid to a subcontractor from a contractor within 90 days of the contractor filing bankruptcy. This favorable decision is a breath of fresh air for construction trust fund creditors paid within 90 days of bankruptcy filing.

The facts are simple, a general contractor made several payments to its subcontractor for past due debts for re-enforcing steel. The payments from the general contractor to the subcontractor were from funds the general contractor had received from the owner, i.e. construction trust funds. Within 90 days of those payments, the general contractor filed for federal bankruptcy protection. The trustee in bankruptcy sought to have the subcontractor repay all monies it was paid by the contractor within the 90 days before the bankruptcy. In bankruptcy parlance, this type of action brought by the trustee against the subcontractor to avoid the payments and obtain repayment is known as a "preference action".

The testimony at trial indicated that the subcontractor had received 100% of what it was owed while other creditors which had not been paid were only going to receive five cents on the dollar. The subcontractor argued that because the funds it was paid were construction trust funds, it did not receive any more than it would have received if the general contractor had been liquidated under Chapter 7 of the bankruptcy code. The burden was on the trustee to prove that the subcontractor had in fact received more that it would have received under this so called "hypothetical" Chapter 7 liquidation.

One of the theories behind preference actions is that it is unfair for a debtor to "prefer" one creditor over another and thus diminish or deplete the debtor's bankruptcy estate. In fact, the preference statutes are designed to prevent a transfer to one creditor diminishing the bankrupts estate which otherwise would be available for distribution to all creditors. However, an exception to this rule is when a creditor received no more than it would have received if the debtor had hypothetically been liquidated.

¹ This article first appeared in the ABC—South Texas Chapter Newsletter.

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² Gardner Law filed a "friend of the court" brief in the 5th Circuit Court of Appeals supporting the subcontractor Palmetco's legal position.

Affirming both the Bankruptcy Court and the federal district court, the 5th Circuit Court of Appeals held that a reasonable general contractor in a hypothetical Chapter 7 would be required to hold amounts it received from an owner in trust for its subcontractor, or face criminal liability for misuse of the trust funds. Because the funds hypothetically would have been held for payment, the subcontractor received no more than it would have received under a Chapter 7 liquidation, thus no preference.
