

Using Article 3-A to Protect Payment Rights in a Construction Bankruptcy

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When general contractors who perform work on construction projects subject to the New York Lien Law file for bankruptcy protection, subcontractors and suppliers that take advantage of the provisions of Article 3-A of the New York Lien Law (New York Lien Law §§70-79-a) can maximize recoveries on their claims against the debtor/contractor and utilize the tools available through the bankruptcy process to obtain greater negotiating leverage and oversight over the debtor/contractor's operations.

Article 3-A of the New York Lien Law

Article 3-A creates a trust fund for monies received in connection with an improvement to real property, and designates the recipient of the funds—whether an owner, general contractor, or first tier subcontractor—as the trustee for such funds until the claims of the limited beneficiaries of the trust fund are paid or discharged. The beneficiaries of the Article 3-A trust fund are limited to, among others, each "subcontractor, architect, engineer, surveyor, labor or materialman" who contributed to the improvement of real property. New York Lien Law §71(2)(A). A separate trust is created for each construction project, and the contractor as trustee is required to maintain separate books and records for each construction project. New York Lien Law §§70(2), 75. The contractor/trustee acquires no property rights in the trust assets until all outstanding claims of Article 3-A trust fund beneficiaries have been paid or discharged. New York Lien Law §70(3).

Trust Fund Assets and Property Of the Estate in Bankruptcy

Upon the filing of a bankruptcy petition, all "legal or equitable interests of the debtor in property" become property of the bankruptcy estate pursuant to §541 of the Bankruptcy Code. However, because property interests in bankruptcy are defined by state law ([Butner v. United States](#), 440 U.S. 48, 55 (1979)), as a result of Article 3-A, any funds received by a debtor/contractor from an owner of a construction project are trust fund assets and do not become "property of the estate" under the Bankruptcy Code immediately upon the filing of a bankruptcy petition. Rather, any beneficial interest in the trust fund assets becomes property of the bankruptcy estate "upon termination of the trust by payment or discharge of all trust claims." New York Lien Law §70(3).

Therefore, when a general contractor files for bankruptcy, a conflict arises between the treatment of Article 3-A trust fund claims for unpaid amounts due on a construction project and claims filed against a debtor/contractor's bankruptcy estate under the Bankruptcy Code. While

subcontractors, suppliers and other Article 3-A claimants can argue that they are not subject to the claims adjudication process set forth in the Bankruptcy Code because their right to payment is from trust fund assets which are not property of the bankruptcy estate, the more prudent course of action is to preserve one's rights by participating in the claims process. Article 3-A claimants can protect their payment rights by filing a proof of claim against the debtor/contractor's bankruptcy estate, asserting a claim secured by the Article 3-A trust fund assets and preserving the right to seek payment of any deficiency from the bankruptcy estate.

Otherwise, by failing to file a proof of claim, an Article 3-A claimant risks waiving its claims against the debtor/contractor's bankruptcy estate. This can be harmful if the construction project finishes "out of the money" and the trust fund assets are insufficient to fully satisfy or discharge the amounts due and owing. In that instance, if the claimant has relied solely on its statutory rights under Article 3-A to recover from the debtor/contractor, it will have waived any right to assert the unpaid balance against the debtor/contractor's bankruptcy estate. Given that construction bankruptcy cases are oftentimes a consequence of a contractor experiencing payment delays and liquidity constraints arising out of one or more construction projects with outstanding payables and other claims, subcontractors, suppliers and other Article 3-A claimants run the risk that the project owner will not pay the debtor/contractor sufficient funds to fully satisfy all trust fund claims.

In addition, because the provisions of the Bankruptcy Code and Bankruptcy Rules state that a debtor's schedules of assets and liabilities (that are not disputed, contingent or unliquidated) and a creditor's filed proof of claim represent prima facie evidence of the validity and amount of claims, Article 3-A claimants must exercise diligence when preparing their proofs of claim. 11 U.S.C. §521(1); FED. R. BANKR. P. 3001(f). If an Article 3-A claimant files proof of a general unsecured claim, or fails to file a proof of claim after being listed as holding a general unsecured claim on a debtor's schedules, it will be presumed to hold a non-priority general unsecured claim in the amount designated. Under these circumstances, a debtor/contractor may argue that by affirmatively designating itself as holding a general unsecured claim against the bankruptcy estate without reference to any payment right from Article 3-A trust fund assets, the claimant has elected to waive its right to payment from trust fund assets and instead chosen to receive payment and discharge of its claim solely from the debtor/contractor's bankruptcy estate.

Accordingly, subcontractors, suppliers and other Article 3-A claimants must exercise care when filing proofs of claim in a debtor/contractor's bankruptcy case to ensure that they preserve their Article 3-A rights and avoid taking actions that could be construed as a waiver of their entitlement to payment in full and discharge of their claims from trust fund assets. To avoid confusion, it is recommended that Article 3-A claimants file secured proofs of claim in order to preserve their rights to payment in full under Article 3-A, as well as to the right to assert any deficiency against the debtor/contractor's bankruptcy estate.

Use of Article 3-A to Obtain Greater Leverage, Control in Bankruptcy Case

Article 3-A claimants can also take steps during the bankruptcy case to protect against the misappropriation of Article 3-A trust funds and obtain relief from the bankruptcy court in the event that trust fund assets are diverted. At the beginning of a bankruptcy case, Article 3-A claimants can object to the debtor/contractor's proposed use of cash collateral on the grounds that the debtor's income stream from construction operations is not property of the bankruptcy estate until all Article 3-A trust fund claims have been paid or discharged. Article 3-A claimants can also ensure that a bankrupt contractor complies with its obligations as a trustee of Article 3-A trust funds by requesting language in a cash collateral order requiring the debtor/contractor to segregate its cash receipts from each construction project in a separate account to ensure that it maintains proper accounting for each Article 3-A trust fund it administers during the bankruptcy case. The monthly operating reports that a debtor is required to file provide a means of verifying the debtor's compliance with its statutory obligations.

In a case where Article 3-A claimants discover that the debtor/contractor has diverted project funds before paying Article 3-A trust fund claims, the Bankruptcy Code offers various remedies, including the appointment of a Chapter 11 trustee "for cause" to operate the business on the grounds that the debtor/contractor's diversion of trust funds amounts to gross mismanagement (11 U.S.C. §1112), or the appointment of a chapter 11 examiner to investigate the debtor/contractor's books and records and obtain a proper trust fund accounting (11 U.S.C. §1104). Alternatively, given the disruption that would result from a displacement of management during a bankruptcy case where the debtor/contractor is continuing to operate on open construction projects, the appointment of a chief restructuring officer provides a solution that would enable an independent neutral party to assume control over the debtor's books and records while providing for the retention of the contractor's principals to continue managing ongoing construction projects. Where diversion of trust funds is suspected, but an Article 3-A claimant does not have the evidence required to successfully move for relief in bankruptcy court, the broad discovery tools available under Bankruptcy Rule 2004 offer another means of obtaining document production and depositions regarding the way the general contractor has been conducting its business and managing its Article 3-A responsibilities.

While a debtor/contractor's bankruptcy filing can initially cause apprehension and confusion for subcontractors, suppliers and other Article 3-A claimants that deal with the general contractor in the operation of its business, the Bankruptcy Code also offers a variety of tools that can give Article 3-A claimants significant negotiating leverage with the debtor/contractor, as well as oversight of the debtor's operations in a way that would be unavailable outside of bankruptcy.

An Article 3-A claimant that is forced to become involved in the bankruptcy process due to a general contractor's filing should first file a secured proof of claim to preserve its statutory rights to trust fund assets under Article 3-A and then determine, based on the circumstances of the case, how best to monitor the debtor/contractor's compliance with its obligations as an Article 3-A trustee during the bankruptcy. By monitoring the debtor's use of the Article 3-A trust funds from the beginning of a bankruptcy case, subcontractors, suppliers and other Article 3-A claimants can ensure that the trust fund assets received during the post-bankruptcy period are not diverted to other uses, thereby increasing the likelihood of payment in full from the trust fund assets.

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