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Fixing Our Infrastructure May Require Fixing the Bankruptcy Code

Preference Actions Threaten Municipal Contractors

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In early 2016, as the Flint, Mich., water crisis unfolded, the city of Detroit was busy pursuing its construction contractors for alleged preferential transfers. These two events — the Flint water crisis and Detroit's preference actions against construction contractors — combine as a cautionary tale that raises an important question: How will financially distressed municipalities fix crumbling infrastructure if construction contractors shy away from public projects for fear of preference claims? While a legislative fix might be the ultimate solution, the predicted rise in municipal bankruptcies means that construction contractors on municipal projects are more likely to get sued for alleged preferences. This article explores that dynamic, as well as defense strategies.

First, a little history. Detroit filed for chapter 9 protection on July 18, 2013. The order for relief was entered on Dec. 5, 2013; on Oct. 22, 2014, Detroit filed its eighth amended adjustment plan. The adjustment plan provided that Detroit was deemed to assume all executory contracts, with certain exceptions (an Aug. 4, 2014, order contained procedures for contract assumption and provided for an "assumed contract list," which Detroit filed shortly after its plan was confirmed). On Nov. 6, 2014, Detroit filed amended exhibits to the adjustment plan, which stated that Detroit retained the right to pursue preference actions against 324 persons and entities, including some of its construction contractors.

Detroit's adjustment plan was confirmed on Nov. 12, 2014, and became effective on Dec. 10, 2014. Due to the plan's deemed assumption of executory contracts, construction contractors (especially those with contracts on the assumed contract list) believed that they were protected from preference exposure for all payments received on those contracts, because Detroit could not assume a contract and *also* seek to recover payments made on that contract during the preference period. However, between Nov. 30, 2015, and Dec. 4, 2015 (*i.e.*, less than two years after the order for relief), Detroit filed approximately 185 preference cases, including claims against construction contractors for alleged preferences.

Construction contractors (and their counsel) were stunned and wondered *how* Detroit could file preference actions against them. In Michigan (and presumably other jurisdictions as well), a construction contractor on a non-municipal project can obtain an enforceable lien against the real estate, thereby becoming a secured creditor. Secured creditor status often shields the contractor from preference exposure because the debtor cannot satisfy 11 U.S.C. § 547(b)(5). Consequently, construction contractors (at least in Michigan) were not accustomed to being sued for preferential transfers.

However, construction contractors on municipal projects in Michigan (and presumably other jurisdictions as well) cannot impose an enforceable lien on municipal property. Consequently, a construction contractor may be an *unsecured* creditor of the municipality and therefore more susceptible to preference exposure.[1] This preference exposure can be large and especially painful for construction contractors due to "pay-if-paid" or "pay-when-paid" clauses that typically appear in contracts between the construction contractor and its subcontractors and suppliers. As a result of these clauses, the construction contractor would have already disbursed much of the money received from the municipality long before the municipality filed its preference complaint.

This "payment waterfall" raises a host of issues. For example, if a construction contractor has to repay a preference, does that mean that the contractor *hasn't* been paid for purposes of a pay-if-paid or pay-when-paid clause? If so, can the contractor sue the subcontractor or supplier to get back money previously paid, or perhaps exert setoff rights to try to "recoup" its preference exposure from the subcontractors and suppliers? Construction attorneys have expressed legitimate concern that a construction contractor's large preference exposure could spawn protracted litigation with subcontractors and suppliers that would be challenging for significant sectors of the construction industry.[2]

Fortunately for construction contractors, various cost-effective defenses may exist. In a preference case, the municipality must prove each element of

1 A leading treatise observed that the application of § 547(b)(5) in a chapter 9 case "is difficult to judge, at best. A court could analyze what creditors would receive if the debtor's property were liquidated and the case proceeded under chapter 7. The analysis is largely theoretical, because a municipality is prohibited from being a debtor under chapter 7." 6 *Colliers on Bankruptcy* ¶ 901.04[23] (Alan N. Resnick and Henry J. Sommer eds., 16th ed.).

2 The authors thank Peter J. Cavanaugh of Cavanaugh & Quesada PLC in Royal Oak, Mich., for his explanation of construction law.

11 U.S.C. § 547(b)[3] and therefore must demonstrate that the transfer at issue was a transfer of the *municipality's* property. However, a municipality's finances are complex and may include special bond revenues and other municipal financing tools. The very nature of municipal financing raises a serious question as to whether the transfer at issue was property of the debtor, as opposed to separate funds raised by issuing a revenue bond to fund a municipal construction project.[4] Thus, it essential to investigate *how* the municipality financed the public project and to request all relevant documents regarding the source of funds for the public project.

If a challenged payment is made from the proceeds of municipal bonds, the "earmarking" doctrine may provide a potent preference defense for the construction contractor. Under the earmarking doctrine, if a third party loans money to a debtor that has been "earmarked" for the purpose of the debtor using that money to pay a designated creditor's claim, those loan proceeds are not the debtor's property. Consequently, the debtor's payment of that "earmarked" money to the creditor is not preferential.[5] The net economic effect of earmarking is that one creditor is simply substituted for another and the debtor's estate is not diminished; therefore, there is no preferential transfer.[6]

To prevail using the earmarking doctrine, a preference defendant must demonstrate that the debtor did not control designating the recipient of the funds made available by the "new creditor."[7] The defense will not be lost merely because the debtor physically receives the funds.[8] Rather, the salient inquiry is whether the debtor had a legal right, by contract or otherwise, to divert the loaned funds to another use or disburse the funds to whomever it wished.[9] Where the agreement between the new lender and the debtor provides that the new funds will be only used to pay a specified creditor, the lender (rather than the debtor) "controls" the funds.[10]

Public construction projects are financed by a variety of mechanisms that may fall into the "earmarking" framework. For example, if a public project is financed through the sale of municipal bonds,[11] the proceeds of those bonds must be applied to the purposes for which the bonds were issued.[12] Money raised by the sale of bonds issued for a particular purpose may not be transferred to a municipality's general fund.[13] In some instances, bonds must recite the purpose of their issue, and, whether it is required or not, such recitals are conclusive evidence of the bond's purpose.[14] Thus, defense counsel should examine whether the terms of the bond indenture or other related financing documents of a public project support an earmarking defense.

The "assumed contract" preference defense is also cost-effective and very useful when defending a preference case brought by a municipality. Municipalities often have many executory contracts and do not want to rewrite them because of bankruptcy. Therefore, contract assumption is likely to be the "default position" in a chapter 9 adjustment plan. Detroit pursued preference actions to recover payments made on some of the construction contracts that were deemed assumed under the adjustment plan (some of which Detroit put on its *own* assumed contract list), thus triggering an "assumed contract" preference defense.

The assumed-contract preference defense is based on two precepts of bankruptcy law. First, contract assumption is inconsistent with avoidance under 11 U.S.C. § 547; consequently, once a contract is assumed, then a preference action against the contract counterparty is barred. Second, § 547(b)(5) cannot be satisfied because § 365 requires, as a condition to contract assumption, that all defaults be cured.[15]

Despite this well-settled law, the municipality might try to "push back" by demanding proof that the construction contract on which payment was made during the preference period was *eligible* for assumption and was *still executory* as of the adjustment plan's effective date. Sharing that proof with the plaintiff's counsel is likely a cost-effective way to achieve dismissal or settlement of the preference case based on the assumed-contract preference defense. If such proof is not readily available, the parties will likely wind up litigating the applicability of the defense, which should be an interesting battle if the municipality designated the contract on its own assumed contract list. Presumably, the *res judicata* or estoppel doctrines will apply. At least one court has held that *res judicata* bars pursuit of a preference case against a nondebtor party whose contract with the debtor has been assumed.[16]

Even if the earmarking and assumed-contract defenses are not available, construction contractors can use all other defenses, including the statutory preference defenses contained in § 547(c). However, those defenses tend to be fact-intensive. Thus, the construction contractor could face an expensive preference defense and, potentially, serious preference exposure — all of which could trigger a cascade of litigation if a construction contractor pursues its subcontractors and suppliers on pay-if-paid and pay-when-paid clauses in their respective contracts. In other words, a construction contractor's serious preference exposure in a municipal bankruptcy *also* could adversely affect subcontractors and suppliers, who may conclude that it is too risky for them to work on municipal projects. Detroit's pursuit of preference cases against its construction contractors (at the same time that the Flint water crisis was so prominently in the news)

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3 Section 547(b) provides that the elements of a preferential transfer are (1) the debtor made a transfer of its property, (2) to or for the benefit of a creditor, (3) for or on account of antecedent debt, (4) during the preference period, (5) while the debtor was insolvent and (6) that said transfer enabled the creditor to receive more than it would have received if the transfer had not been made and the creditor received what it would have gotten in a chapter 7 liquidation. *See* 11 U.S.C. § 547(b).

4 The authors also thank Lisa A. Lee of Ice Miller LLP in Indianapolis for her explanation of municipal finance.

5 *See, e.g., In re Hartley*, 825 F.2d 1067, 1070 (6th Cir. 1987).

6 This would not necessarily be the case where a secured creditor takes the place of an unsecured creditor. *See In re Heitkamp*, 137 F.3d 1087, 1089 (8th Cir. 1998).

7 *See Coral Petroleum Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1356 (5th Cir. 1986).

8 *Id.* at 1362.

9 *In re Superior Stamp & Coin Co. Inc.*, 223 F.3d 1004, 1009 (9th Cir. 2000).

10 *Id.* Some courts require that the loan agreement be performed according to its terms in order for earmarking to apply. *See In re Bohlen Enters. Ltd.*, 859 F.2d 561, 566-67 (8th Cir. 1989). Ironically, a debtor's violation of the terms and conditions upon which the loan was made may rob a preference defendant of the earmarking defense. Other courts implicitly reject such an unjust outcome, and hold that a debtor's improper use of funds does not render the funds property of the debtor's estate. *See In re Computrex*, 403 F.3d 807, 812 (6th Cir. 2005).

11 Public improvements (such as waterworks, lighting, sewers, sanitation and drainage) might be funded by special-assessment and improvement bonds issued by a municipality. 15 *McQuillin Mun. Corp.* § 43:37 (3d ed. 2016).

12 *Id.* § 43:69.

13 *Id.*

14 *Id.* § 43:110.

15 *See, e.g., In re Superior Toy Mfg. Co. Inc.*, 78 F.3d 1169 (7th Cir. 1996); *In re Kiwi Int'l Air Lines Inc.*, 344 F.3d 311 (3d Cir. 2003); *In re Greater Se. Cmty. Hosp. Corp. I*, 327 B.R. 26 (Bankr. D. D.C. 2005).

16 *See In re Phoenix Rest. Grp. Inc.*, Nos. 301-12036 and 303-573A , 2005 WL 114327, at *11-*12 (Bankr. M.D. Tenn. Jan. 10, 2005).

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highlights this important question: How will debt-burdened municipalities fix their infrastructures if construction contractors (or the subcontractors or suppliers) "shy away" from public projects for fear of preference exposure if the municipality files for bankruptcy?

Legislative Option

Perhaps chapter 9 of the Bankruptcy Code should be amended to prevent municipalities from pursuing preference actions against any persons and entities involved in any municipal construction project. Because municipal projects require both goods and services (*e.g.*, engineering services), any such Bankruptcy Code amendment should be broad enough to protect providers of both goods *and* services. Alternatively, the Code could be amended to provide a "safe harbor" for persons and entities involved in municipal construction projects, perhaps akin to 11 U.S.C. §§ 546(d)-(j).

The predicted rise in municipal bankruptcies and our crumbling infrastructure represent serious looming social and economic problems. Municipalities need the expertise of the construction industry to repair their infrastructures, but the Detroit bankruptcy was a rude awakening for the construction industry. To ensure that the Bankruptcy Code does not contain a *disincentive* that dissuades the construction industry from fixing the infrastructures of debt-burdened municipalities, Congress may need to fix the Bankruptcy Code itself. abi

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