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ONE REASON TO ENFORCE PAYMENT BOND AND MECHANIC'S LIEN RIGHTS PROMPTLY

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There are many reasons why a party to a construction project should promptly file a payment bond claim or a mechanic's lien claim when those rights mature. The U.S. Court of Appeals for the Fourth Circuit recently emphasized this point in the bankruptcy context. In *United Rentals, Inc. v. Angell*, No. 09-1209 (Jan. 22, 2010), the Fourth Circuit upheld a bankruptcy court judgment allowing a bankruptcy trustee to avoid and recover $66,963.74 as preferential payments made by Partitions Plus of Wilmington, Inc. ("Partitions") to United Rentals, Inc. ("United") during the 90 days prior to Partitions' bankruptcy petition. At issue was United's failure to make a payment bond or mechanic's lien claim prior to receiving Partitions' payments, which the Fourth Circuit determined was fatal to United's argument that the payments were contemporaneous exchanges for new value because they extinguished United's right to enforce its claims.

As background, United had subcontracted with Partitions to supply rental equipment for multiple construction projects, and Partitions had executed payment and performance bonds for several of those projects. Partitions then filed a Chapter 11 bankruptcy petition that was converted to a Chapter 7 proceeding. However, in the 90-day period prior to its bankruptcy filing, Partitions made three payments (the "transfers") to United for amounts owed for United's prior provision of rental equipment.

The bankruptcy trustee sought to avoid and recover the transfers as preferential payments under 11 U.S.C.A. § 547(b), arguing that the transfers were made (1) for the benefit of United, (2) on account of antecedent debts owed by Partitions before the transfers were made, (3) while Partitions was insolvent, (4) within 90 days before Partitions filed its bankruptcy petition, and (5) to enable United to receive more than it would have received from Partitions' Chapter 7 bankruptcy on the debt the transfers extinguished if the transfers had not been made.

United denied that the transfers were avoidable, asserting, among other things, a defense under 11 U.S.C.A. § 547(c)(1) that the transfers were substantially contemporaneous exchanges for new value because they extinguished its right to obtain payment through Partitions' bond and to file and enforce a mechanic's lien. Under § 547(c)(1), a transfer cannot be avoided "to the extent [it] was . . . intended by the debtor and the creditor to or for whose benefit [it] was made to be a contemporaneous exchange for new value given to the debtor; and [it] in fact [was] a substantially contemporaneous exchange."

For its bond argument, United claimed that it could have received full payment from the surety if Partitions had not made the transfers. United argued that if it had filed a claim for payment and if the surety had paid the claim, the surety would have automatically received an equitable lien by subrogation against the funds the general contractors owed Partitions. Thus, according to United, new value was given to Partitions in the form of the money that Partitions eventually received from the general contractors — money that otherwise might have been paid to the surety had a claim been filed.

For its mechanic's lien argument, United claimed that if the transfers had not been made, it could have pursued its right to file a mechanic's lien under North Carolina law on the real property improved by one of the construction projects. Thus, according to United, the transfers had the effect of discharging its right to file and enforce the lien, which in turn provided new value to Partitions in the form of money that Partitions retained by not having to face any resulting offset claims by the encumbered property owner.

The bankruptcy court rejected both arguments — a decision affirmed by the U.S. District Court for the Eastern District of North Carolina and the Fourth Circuit. The Fourth Circuit specifically found that United never provided new value to Partitions in exchange for the transfers because United had not perfected any lien or security interest in property to secure Partitions' debts and, therefore, had no interest to release in exchange for the transfers. Furthermore, the surety did not have an equitable lien to release because it had not paid a claim on the bond. Thus, the only benefit that Partitions received from United was the extinguishment of its existing debts, which does not qualify as new value for the purposes of a § 547(c)(1) defense.

While the Fourth Circuit's decision reviewed lien rights under North Carolina law and the nuances of these rights vary from state to state, the decision is nevertheless an important reminder that parties to a construction project should consider enforcing their bond and lien rights as soon as they mature. Had United filed a claim on the payment bond or sought to enforce a mechanic's lien before the transfers were made, United may have obtained a security interest that it could have released in exchange for the transfers from Partitions during the 90-day preference period. This contemporaneous exchange for new value, in turn, may have enabled United to defeat the bankruptcy trustee's preferential payment action instead of refunding almost $67,000 to the trustee.

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