

SUBJECT: Securing subcontractor trustee account payments from bankruptcy claims

COMMITTEE: Business and Industry — favorable, without amendment

VOTE: 8 ayes — Deshotel, Elkins, England, Gattis, Giddings, S. Miller, Orr,
Quintanilla

0 nays

3 absent — Christian, Keffer, S. Turner

WITNESSES: For — Richard McCormack, William (Jason) Walker, Associated Builders
and Contractors of Texas; (*Registered, but did not testify*: Jon Fisher,
Associated Builders and Contractors of Texas)

Against — None

BACKGROUND: Under Property Code, ch. 162, the Texas Construction Trust Fund Act,
construction payments are considered to be trust funds if the payments are
made to a contractor or subcontractor or to an officer, director, or agent of
a contractor or subcontractor, under a construction contract for the
improvement of specific real property.

The contractor is the trustee of the funds, and a subcontractor who
provides labor or material for a specific improvement is a beneficiary of
the trust fund. Misapplying trust funds is a class A misdemeanor (up to
one year in jail and/or a maximum fine of \$4,000).

The U.S. Bankruptcy Code, 11 U.S.C. sec. 547, establishes a preference
among creditors to help provide a more equitable distribution of the assets
of the person or firm filing for bankruptcy. Sec. 547 allows the bankruptcy
trustee to recoup a “transfer” of property if it were made:

- to or for the benefit of a creditor;
- for payment of a pre-existing debt;
- on or within 90 days before the filing of the bankruptcy petition; or
- to enable a creditor to receive more than if the case had been filed
under chapter 7 of the Bankruptcy Code.

On August 18, 2008, the Fifth U.S. Circuit Court of Appeals, in *NA Flash Foundation Inc.*, upheld bankruptcy and district court rulings that the Texas Construction Fund Act would prevent a trustee from recouping payments to a subcontractor for re-enforcing steel as a preferential transfer prohibited by 11 USC, sec. 547 (b).

DIGEST:

HB 1513 would amend Property Code, sec. 162.001 to state that any payments made to a subcontractor from a construction trust fund would not be considered an asset of a contractor who had filed for bankruptcy. The change would apply to any public or private construction project whether its contract was covered by a statutory or common law property bond.

Commingling of trust funds with other contractor funds would not prevent a subcontractor from claiming this protection from recovery in a bankruptcy proceeding.

The bill would take effect on September 1, 2009.

**SUPPORTERS
SAY:**

HB 1513 would clamp down on what has become a loophole in the Construction Trust Fund Act. Aggressive bankruptcy trustees, who receive a portion of the recovered assets, have clipped away at the statute in efforts to claim payments to subcontractors as assets of the debtor. Traditionally, the act has been simple but powerful. Unlike a mechanic's lien, provided for in the Texas Constitution or elsewhere in the Property Code, there are no procedural requirements made of a subcontractor or materialman before they qualify for protections under the Construction Trust Fund Act. The bill would help restore those safeguards.

HB 1513 would provide a clear and unambiguous statement of policy by the Legislature, compared with varying interpretations in case law. The Fifth Circuit upheld protections of the Construction Trust Fund Act in *NA Flash Foundation Inc.*, but that decision was based on the bankruptcy and district courts' comparison with a hypothetical Chapter 7 bankruptcy filing. The bill would remove any doubts on how to apply the standard.

Commercial construction jobs are too complex to wait for full payment at the end of the construction project. Consequently, payments are broken up into monthly progress payments. Unlike other industries, construction contractors and suppliers cannot spread their risks in the manner of a grocer or merchants with many customers. If the upstream contractor goes

bankrupt, there is a significant chance it could take subcontractors with it, multiplying the loss to the economy and the owner. Allowing further recovery from subcontractors in bankruptcy proceedings would exacerbate the situation and add more uncertainty in these economically stressful times.

**OPPONENTS
SAY:**

HB 1513 would be an unnecessary “belt-and-suspenders” approach to a question already decided by state law and court decisions. Subcontractors already have sufficient protections in bankruptcy proceedings.

NOTES:

The companion bill, SB 1137 by Jackson, is scheduled for a public hearing by the Senate Business and Commerce Committee on April 21.