N O T E S O N

DEBTOR/CREDITOR

R E L A T I O N S

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Subcontractor Trumps Bank

Many states, including Maryland, have enacted construction trust fund statutes. These require a construction contractor to hold funds received from the owner or general contractor on the job in trust for payment to subcontractors and suppliers. Typically, the statutes prohibit diversion of construction contract payments to other uses until subcontractors and suppliers have been paid.

Earlier this year, an Ohio bankruptcy court was required to determine the extent of a bank's security interest in construction contract proceeds subject to the Michigan trust fund statute. The bank had loaned funds and taken a security interest in contract proceeds as collateral. The court decided that the bank's security interest attached only to the amounts which exceeded the borrower's obligations to subcontractors and suppliers. The bank's security interest in the receivables turned out to be only a security interest in the profits, if any, of its borrower, rather than the receivables as a whole.

Briggs Electrical Contracting Services, Inc. v. Elder-Beerman Stores Corp. (In re Elder Beerman Stores Corp.), 221 B.R. 404 (Bankr. S. D. Ohio 1998).

One Hand Gives, the Other Hand Takes

Weighing in on an issue which has divided bankruptcy courts, a federal appeals court in Chicago has ruled that all agencies of the federal government are considered to be a single entity for the purpose of exercising the setoff rights recognized under bankruptcy law.

General rules of setoff permit a creditor that also owes money to a debtor to set off the two obligations against each other.

A situation arose where a debtor in bankruptcy was owed money by the Navy under a construction contract and at the same time owed money to the Small Business Administration to repay a loan. The court ruled that all agencies of the government are a single entity for these purposes, thus enabling the SBA to capture the Navy's payment to the debtor rather than receiving a pro rata distribution from the bankruptcy case.

United States v. Maxwell, 157 F.3d 1099 (7th Cir. 1998).

You Can Always Pay the Bank

As a general principle, a Chapter 11 debtor is not permitted to pay creditors whose debts arose prior to commencement of the Chapter 11 case, except in accordance with a plan of reorganization confirmed by the court or, in special cases, a separate court order.

However, a Florida Bankruptcy Court recently determined that ordinary payments to a secured creditor in the normal course of business, made after filing of a Chapter 11 petition but before the confirmation of a plan, are permissible even without court authorization.

Dzikowski v. Southtrust Bank (In re Family Health Food U.S.A., Inc.), 223 B.R. 250 (Bankr. S.D. Fla. 1998).

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