No. 09-

IN THE

Supreme Court of the United States

UNITED RENTALS, INCORPORATED,

Petitioner,

v.

JAMES BIGELOW ANGELL,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

JAMES D. FULLERTON
Counsel of Record
RICHARD I. HUTSON
PAUL SCHRADER
FULLERTON & KNOWLES, PC
12642 Chapel Road
Clifton, VA 20124
(703) 818-2600
jfullerton@fullertonlaw.com

Attorneys for Petitioner

229993

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

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QUESTIONS PRESENTED

1. In order to satisfy the elements of 11 U.S.C. § 547(b), must a bankruptcy trustee prove that the allegedly preferential transfers diminished the bankruptcy debtor's estate available for distribution to general unsecured creditors?

2. Is the contemporaneous release of contingent setoff rights or a contingent security interest in property of the estate by a third-party as a direct result of an alleged preferential transfer a valid contemporaneous exchange for new value under 11 U.S.C. § 547(c)(1)?

RULE 29.6 CORPORATE DISCLOSURE STATEMENT

Petitioner, United Rentals, Inc., has no parent corporation and no publicly held company owns 10% or more of its stock.

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PETITION FOR A WRIT OF CERTIORARI

United Rentals, Inc. ("United Rentals") respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case.

OPINIONS BELOW

The January 22, 2010 opinion of the Court of Appeals for the Fourth Circuit is reported at 592 F.3d 525 and reproduced in the appendix hereto ("App.") at 1a.

The January 22, 2009 Order of the United States District Court for the Eastern District of North Carolina affirming the judgment of the bankruptcy court is unpublished and reproduced at App. 19a.

The April 30, 2008 Order of the Bankruptcy Court for the Eastern District of North Carolina granting the Trustee's motion to amend the judgment and denying United Rentals motion to stay is unpublished and reproduced at App. 27a. The March 31, 2008 Order of the bankruptcy court granting judgment in the amount of $66,963.74 to the Trustee is unpublished and reproduced at App. 34a. The June 14, 2007 Order of the bankruptcy court granting the Trustee's motion for summary judgment, and denying in part and granting in part United Rentals' motion for summary judgment is unpublished and attached hereto at App. 39a.

The February 19, 2010, order of the Court of Appeals for the Fourth Circuit denying United Rental's petition for rehearing or rehearing en banc is reproduced at App. 51a.

JURISDICTION

The judgment of the court of appeals was entered on January 22, 2010. App. 1a. On February 19, 2010, that court denied a timely filed petition for rehearing or rehearing en banc. App. 51a. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 547(b) of the Bankruptcy Code, 11 U.S.C. § 547(b), provides:

> (b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made—
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Section 547(c)(1) of the Bankruptcy Code, 11 U.S.C. § 547(c)(1), provides:

(c) The trustee may not avoid under this section a transfer—

(1) to the extent that such transfer was—

(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

(B) in fact a substantially contemporaneous exchange;

STATEMENT OF THE CASE

I. Introduction

"The Bankruptcy Code's preference section serves two goals." App. 3a. "First, it prevents companies from 'racing to the courthouse to dismember the debtor during his slide into bankruptcy.'" App. 3a. "And second, it protects 'equality of distribution among creditors of the debtor.'" App. 3a. This case is about the interplay between those Bankruptcy Code preference provisions and mechanic's lien rights under state statute or payment bond rights under the federal Miller Act, state Little Miller Acts and private payment bonds. It raises the important question how a contractor who was protected by these remedies before receiving payment can be subject to a preference claim to recover payments received, while a contractor who was not paid retains those protections and the ability to receive payment even after the debtor files bankruptcy. The Fourth Circuit's decision in this case conflicts with the decisions of other circuits and creates the inequitable and illogical scenario where a construction contractor is prejudiced by accepting payment for its work.

It is not uncommon for a construction contractor to suffer financial difficulties that threaten to stall work on construction projects because of nonpayment to subcontractors and suppliers. To limit this risk of nonpayment and the resulting consequences of delayed and higher cost construction projects, state legislatures passed mechanic's lien statutes to provide security to construction contractors on private construction projects. Similarly, the federal government recognized the importance of assuring payment to construction contractors on public construction projects and passed the Miller Act, requiring payment bonds for the protection of construction contractors. The legislatures of every state in the country followed suit with a so-called "Little Miller Act" for the same purpose. All of these statutes recognize the economic importance of protecting construction contractors and facilitating lower priced construction projects through limitations on risks.

Despite clear conflicts with the decisions of other circuits, the Fourth Circuit's decision in this case denies that preferred status to the very creditors those laws seek to protect. The result of this decision is that, in the event of bankruptcy, a construction contractor is only protected from the risk of nonpayment if that contractor does not receive payment. An unpaid contractor is protected by these remedial mechanisms and can collect payment for its work, despite the bankruptcy. In contrast, a contractor who has been paid is prevented from pursuing these remedies and is then forced to return the payments to the debtor at a time beyond the deadlines to preserve any remedy. The paid contractor retroactively becomes unprotected. This is exactly what the state legislatures and the federal government have sought to prevent through legislation.

The consequences of this decision on the construction industry are immeasurable. The only way a construction contractor can protect itself against a later preference claim is to refuse payment from a debtor and instead actually file its payment bond claim or mechanic's lien prior to accepting payment. This works against the very purpose of the preference provisions and promotes dismemberment of the debtor during his slide into bankruptcy. Rather than preventing the race to the courthouse, the Fourth Circuit has made it mandatory.

This Court should grant certiorari to resolve the conflicts created by the Fourth Circuit's decision and to prevent this unwarranted encroachment on the long-held protections of construction contractors established by contract, and state and federal law.

II. Factual Background

Prior to filing its bankruptcy petition on September 1, 2004, Partitions Plus of Wilmington, Inc. ("Partitions") was working as a subcontractor for Bovis Lend Lease, Inc. on a construction project known as Dosher Memorial Hospital ("Dosher Project"). Partitions enlisted United Rentals, Inc. ("United Rentals") to supply the rental equipment needed. Throughout the Dosher Project, United Rentals provided various rental equipment to Partitions on an open account and periodically received payments from Partitions. United Rentals last supplied rental equipment to Partitions for use on the Dosher Project on June 1, 2004.

During that same time, Partitions was also working as a subcontractor for EMJ Corporation on a construction project known as Mayfair Town Center ("Mayfair Project"). Partitions was similarly using rental equipment rented from United Rentals on that project. United Rentals' last supply of rental equipment to Partitions for the Mayfair project was on September 22, 2004.

On both the Dosher Project and the Mayfair Project, Partitions entered into payment bonds with United States Fire Insurance Company ("U.S. Fire") for the protection of those supplying labor, materials and rental equipment to Partitions. Under the terms of the payment bonds on these projects, United Rentals could have asserted a claim against U.S. Fire for any monies owed to United Rentals for rental equipment used on the projects. A suit against U.S. Fire on the payment bonds could have been commenced until the "expiration of the minimum period of limitation permitted by any law."

North Carolina law gives a subcontractor "a lien upon funds that are owed to the contractor with whom the . . . subcontractor dealt and that arise out of the improvement on which the . . . subcontractor worked or furnished materials." N.C. GEN STAT. §44A-18 (2010). United Rentals provided undisputed evidence that the contractors with whom Partitions dealt owed Partitions amounts greater than the amount of the alleged preferential transfers both at the time of the transfers and as of the date the petition was filed.

North Carolina law also provides a claim of lien on real property that must be filed within 120 days of the last supply of work to the project. N.C. GEN. STAT. § 44A-12 (2010). Pursuant to this statute, United Rentals had until January 20, 2005 to perfect its lien on real property rights on the Mayfair Project.[1]

1. The North Carolina lien on funds, applicable to both projects, and the North Carolina lien on real property, applicable only to the Mayfair Project are hereinafter collectively referred to as "mechanic's liens."

As of the date of the alleged preferential transfers and the date of Partitions' bankruptcy petition, United Rentals was still within any deadline to make a claim against U.S. Fire or to file mechanic's liens. For the common sense reason that it had received payment of the monies owed on these projects, United Rentals never made a claim against the bonds or filed any mechanic's liens related to either project.

III. Bankruptcy Court Proceedings[2]

On September 1, 2004, Partitions filed a chapter 11 bankruptcy petition in the Bankruptcy Court for the Eastern District of North Carolina. On November 4, 2004, the case was converted to a chapter 7 proceeding and James B. Angell was appointed Trustee for the liquidation (Mr. Angell is hereinafter referred to as the "Trustee").

On July 14, 2006, the Trustee filed a complaint in the bankruptcy court seeking to recover $75,849.40 from United Rentals pursuant to 11 U.S.C. § 547 and 11 U.S.C. § 550(a). App. 40a-41a. The bankruptcy court had jurisdiction over the Trustee's complaint pursuant to 28 U.S.C. §§ 157 and 1334. This Complaint alleged that $75,849.40 in transfers were made to United Rentals for or on account of an antecedent debt while the debtor was insolvent and that these transfers were made within 90 days of the date of the petition date.[3] App. 42a. Most

2. The discussion of the bankruptcy court proceedings is limited to those issues relevant to the question presented in this writ.

3. United Rentals did not dispute any of these allegations at summary judgment or trial.

importantly for this appeal, the Trustee further alleged that the transfers "enabled the Defendant to receive more from the Debtor than it would have received in a Chapter 7 case had the transfers not been made and the Defendant received payment on its claim to the extent provided by Title 11 of the United State Code." App. 42a.

United Rentals moved for summary judgment on the basis that the Trustee could not show that the alleged preferential payments enabled United Rentals to receive more than it would have if the transfer had not been made. App. 5a. The Trustee filed a cross-motion for summary judgment on this issue asserting that it had met its burden under § 547(b) by showing that general unsecured creditors would not receive one hundred percent of their claims from the assets of the bankruptcy estate. App. 5a.

The court ruled that the Trustee had met his burden of proof and granted the Trustee's motion for summary judgment. App. 48a. It reasoned that, while United Rentals argued it would have received payment in full from the surety had it not been paid, the court's analysis is limited to "whether in a chapter 7 liquidation there would have been enough funds to pay this creditor's claim *out of the estate*." App. 48a (emphasis added).

This matter then proceeded to trial on February 28, 2008 on United Rentals' affirmative defenses. At trial, United Rentals presented the argument that the release of its inchoate mechanic's lien rights and its rights against the payments bonds at the time of the alleged preferential transfers constituted a contemporaneous exchange for new value under 11 U.S.C. § 547(c)(1). The bankruptcy court, relying on its own unpublished opinion issued eleven days before in *Angell v. Pennington*, Adv. Pro. 06-00148-8-AP (Bankr. E.D.N.C. March 20, 2008), set forth a two part test to determine whether such a defense existed. App. 37a. This test required that a creditor show "(1) it would have timely filed a claim against the project's payment bond and been paid in full had it not received payment from the debtor, and (2) at the time, the debtor was still owed funds by the general contractor on which the bonding company could have asserted a lien." App. 37a.

United Rentals presented undisputed evidence establishing element two of the *Angell v. Pennington* test. This evidence showed that the owners and general contractors on both projects were holding funds in excess of the alleged preferential payments both at the time of the transfers and at the time of bankruptcy petition. App. 37a.

The bankruptcy court, however, focused on the first element of its self-created test in making its decision. App. 37a-38a. It determined that because United Rentals had not established that it "would have filed a bond claim and been paid in full had it not received the preferential payment," the contemporaneous exchange for value defense of § 547(c)(1) was not available to United Rentals. App. 37a-38a.

Relying on *Precision Walls v. Crampton (In re Precision Walls)*, 196 B.R. 299 (E.D.N.C. 1996), the bankruptcy court determined that United Rentals was an unsecured creditor because it had not perfected its lien rights prior to receiving payment from Partitions. App. 36a. The court deemed this opinion dispositive of United Rentals' 547(c)(1) defense based on the release of its inchoate mechanic's liens and found in favor of the Trustee on this argument.[4] App. 36a.

On these bases the court ruled that United Rentals did not have a valid defense to the claim of the Trustee and that the transfers could be avoided as preferential. App. 38a. On March 31, 2008, the bankruptcy court entered judgment in favor of the Trustee in the amount of $66,963.74. App. 38a.

IV. The District Court Decision

United Rentals appealed the bankruptcy court's decisions at summary judgment and trial to the United States District Court for the Eastern District of North Carolina. The district court had jurisdiction over United Rentals' appeal pursuant to 28 U.S.C. §§ 158 and 1334. On January 2, 2009, without holding oral argument, the district court issued an unpublished order affirming the bankruptcy court's decision. App. 19a-26a.

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4. Throughout this litigation the Trustee has never been able to point to any case outside of the Eastern District of North Carolina that required a creditor prove that it had actually perfected mechanic's lien or bond rights prior to payment or to prove what it would have done absent payment for the purposes of a § 547(c)(1) defense. This test, which became the law of this case until Fourth Circuit review, is a creation of the bankruptcy court and district court of the Eastern District of North Carolina alone.

The district court held that the Trustee had proved that United Rentals received more than it would have had the transfers not occurred. App. 24a. This determination was based on the Fourth Circuit's opinion in *Smith v. Creative Financial Mgmt, Inc. (In re Virginia-Carolina Fin. Corp.)*, 954 F.2d 193 (4th Cir. 1992) and the statement therein that "[t]he court must focus, not on whether a creditor may have recovered all of the monies owed by the debtor from any source whatsoever, but instead upon whether the creditor would have received less than a 100% payout in [a] Chapter 7 liquidation." App. 24a. Because United Rentals would not have received one hundred percent of the allegedly preferential transfers as a general unsecured creditor *directly from the estate* in the hypothetical chapter 7, the court determined the Trustee had met its § 547(b) burden. App. 24a. The court undertook no analysis of the actual impact of the transfers on the estate. App. 24a.

The district court also affirmed the two part test created by the bankruptcy court to determine if United Rentals had § 547(c)(1) defense because of its bond rights. App. 25a.

The district court gave only a cursory review to United Rentals' release of inchoate mechanic's liens. In fact, the only determination made by the court in affirming the bankruptcy court summary judgment order was that "Appellant is an unsecured creditor because it failed to file notice." App. 24a. Like the bankruptcy court, the district court reached this conclusion by reference to its own decision in *Precision Walls v. Crampton (In re Precision Walls)*, 196 B.R. 299 (E.D.N.C. 1996). App. 24a.

On these bases, the district court affirmed the bankruptcy court's grant of summary judgment to the Trustee and denial of United Rentals' contemporaneous exchange for new value defense.

V. The Court of Appeals Decision

United Rentals then appealed to the Fourth Circuit Court of Appeals arguing that the Trustee failed to meet its burden of proof under 11 U.S.C. § 547(b) and that United Rentals had established a defense pursuant to 11 U.S.C. § 547(c)(1). The Fourth Circuit had jurisdiction over United Rentals' appeal pursuant to 28 U.S.C. § 158.

Looking first at the question of whether the Trustee had met it burden of proof under § 547(b), the Fourth Circuit, like the district court before it, relied on its decision in *Virginia-Carolina Financial Corporation* to reason that the proper analysis is not what the specific creditor would have received had the transfers not been made, but what the creditor would have received as a general unsecured creditor *directly from the bankruptcy estate* had the transfer not been made. App. 9a-10a. On this basis, the court affirmed the holding below. App. 9a-10a, 18a.

Looking next at the § 547(c)(1) defense argued by United Rentals, the court the considered the "indirect transfer theory." App. 10a-17a. The Fourth Circuit did not discuss the bankruptcy court's two-element test. *See generally* App. 1a-18a. Rather it based its decision on the fact that "the Surety never obtained any lien that it could release." App. 13a. Under this reasoning, the necessary consideration is whether the surety held a lien at the time of the payment, not whether United Rentals could have and would have made a claim against the payment bonds. App. 13a. As the allegedly preferential $66,963.74 was paid to United Rentals by Partitions rather than U.S. Fire, no such lien existed and United Rentals had no contemporaneous exchange for new value defense based upon an indirect transfer. App. 14a.

Unlike the district court, the Fourth Circuit also considered United Rentals' inchoate mechanic's liens in the context of the contemporaneous exchange for new value defense. The court reasoned that "United [Rentals] did not have a security interest to release because it never filed the mechanic's lien claim necessary to obtain such an interest." App. 15a. In support of this position, the court reviewed the North Carolina mechanic's lien statutes and determined that the "North Carolina's mechanic's lien statutes grant a supplier of labor and material only *the right to file a claim of lien* on real property." App. 16a. (emphasis in original). The court then held that, because United Rentals had nothing more than a right to file a lien and had not exercised that right before payment, it had nothing to release at the time of the transfers and therefore no defense under 11 U.S.C. 547(c)(1). App. 16a-17a.

United Rentals filed a timely petition for rehearing or rehearing en banc, which the court denied on February 19, 2010. App. 51a.

REASONS FOR GRANTING THE PETITION

I. The Decision Below Conflicts with the Decisions of Other Circuit Courts

The petition should be granted because the Fourth Circuit's opinion conflicts with the decisions of other circuit courts. *See* S. Ct. Rule 10(a). Because of this conflict, the protection afforded a construction contractor by a payment bond or mechanic's lien statutes when a bankruptcy intervenes will vary depending on the geographical location of the construction project. This Court should not allow this inconsistent application of bankruptcy law and the resulting confusion to exist, and should grant certiorari.

A. The decision of the Fourth Circuit conflicts with decisions of the Sixth Circuit requiring a showing that the bankruptcy estate was diminished for a transfer to be preferential under 11 U.S.C. § 547(b).

Under the Bankruptcy Act, it was unquestionable that a transfer had to diminish the estate to be avoided as preferential. *See Nat'l Bank of Newport v. Nat'l Herkimer County Bank*, 225 U.S. 178, 184, 32 S. Ct. 633, 56 L. Ed. 104 (1912) ("the act condemns, . . . the appropriation by the insolvent debtor of a portion of his property to the payment of a creditor's claim, so that thereby the estate is depleted and the creditor obtains an advantage over other creditors"); *Bailey v. Baker Ice Machine Co.*, 239 U.S. 268, 274, 36 S. Ct. 50, 60 L. Ed. 275 (1915) ("It therefore is plain that § 60b [of the Bankruptcy Act] refers to an act on the part of a bankrupt whereby he surrenders or encumbers his property or some part of it for the benefit of a particular creditor and thereby diminishes the estate").

In twenty-plus years of precedent, the Sixth Circuit has retained this element, holding that to satisfy § 547(b) a trustee must show that the alleged preferential transfers diminish the estate available to unsecured creditors. *See Chase Manhattan Mortgage Corp. v. Shapiro (In re Lee)*, 530 F.3d 458, 464 (6th Cir. 2008) ("Although § 547(b) does not expressly make diminution of the estate an element of a preference claim, diminution is understood to be a requirement as a result of § 547(b)(5)'s improvement-in-position test"); *Stevenson v. Leisure Guide of America, Inc. (In re Shelton Harrison Chevrolet, Inc.)*, 202 F.3d 834, 836-37 (6th Cir. 2000) ("Specifically, the bankruptcy trustee may avoid any transfer of the debtor's property to a creditor . . . that diminishes the estate") (internal quotation marks omitted); *McLemore v. Third National Bank (In re Montgomery)*, 983 F.2d 1389, 1394 (6th Cir. 1993) ("We agree, of course, that a voidable preference necessarily depletes the debtor's estate; without such a depletion, there cannot be a voidable preference"); *Waldschmidt v. Mid-State Homes, Inc. (In re Pitman)*, 843 F.2d 235, 238 (6th Cir. 1980) (stating that § 547(b) "declares that the bankruptcy trustee 'may avoid any transfer' of the debtor's property to a creditor 'for or on account of an antecedent debt owed by the debtor before such transfer was made' that diminishes the estate or creates an inequality among classes of creditors").

In its 2008 opinion in *In re Lee*, the Sixth Circuit could not have been clearer that dimunition of the estate is a necessary element of § 547(b). There the court wrote, "[t]he concept here is the same as the idea developed in old Supreme Court opinions under old bankruptcy acts—that a voidable preference must 'impair,' or 'diminish,' the estate." *In re Lee*, 530 F.3d at 464. Although not as explicit, the Eleventh Circuit has also deemed it necessary under § 547(b) to analyze whether an alleged preferential payment diminished the estate. In *Bank of America N.A. v. Mukamai (In re Egidi)*, 571 F.3d 1156 (11th Cir. 2009), the Eleventh Circuit extensively analyzed the effect of a transfer on the debtor's estate, to determine whether the bankruptcy trustee had satisfied § 547(b). *Id.* at 1161. The court ultimately determined that "[b]ecause the transfer was within the control of . . . the debtor, and the transfer diminished the assets in the estate available to other creditors, the transfer was a preference, which could be avoided by the trustee." *Id.* at 1162.

Similarly, the Eighth Circuit in *Wells Fargo Home Mortgage, Inc. v. Lindquist*, 592 F.3d 838 (8th Cir. 2010), performed an analysis of whether the alleged preferential transfer diminished the estate to determine whether § 547(b)(5) was satisfied. *Id.* at 844-45. Ultimately the court concluded that "the transfer of the mortgage to [creditor] diminished the bankruptcy estate" and affirmed the holding of the bankruptcy court that the trustee had satisfied § 547(b)(5). *Id.* at 845.

The Fifth, Seventh and Tenth Circuits also continually include diminishment principles in § 547(b) elements. *See Caillouet v. First Bank & Trust (In re Entringer Bakeries Inc.)*, 548 F.3d 348 (5th Cir. 2008) (noting that the earmarking doctrine is based on the concept that the transfer "in no way diminishes the debtor's estate."); *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 135 (5th Cir. 1986) ("For the preference to be voided under section 547, it is essential that the debtor have an interest in the property transferred so that the estate is thereby diminished") (internal quotation marks omitted); *Warsco v. Preferred Technical Group*, 258 F.3d 557, 564 (7th Cir. 2001) (noting that "[c]ourts considering [§ 547(b)] have focused on whether the transfer diminished the debtor's estate"); *In re Smith*, 966 F.2d 1527, 1535 (7th Cir. 1992) ("But courts have also long held that to be avoidable, transfers must result in a depletion or diminution of the debtor's estate"); *Parks v. FIA Card Services, N.A. In re Marshall)*, 550 F.3d 1251, 1257-58 (10th Cir. 2008) (considering whether the estate was diminished in determining whether § 547(b) was satisfied).

The Fourth Circuit disagrees. Before the Fourth Circuit and the lower courts, United Rentals argued that the Trustee had failed to meet its burden of proof under 11 U.S.C. § 547(b) because it had not shown that the alleged preferential transfer diminished the estate available to the unsecured creditors of Partitions. This argument was based on this Court's decision in *Pearlman v. Reliance Insurance. Company*, 371 U.S. 132, 83 S. Ct. 232, 9 L. Ed. 2d 190 (1962), where it was held that a surety on a construction project has an equitable lien against funds owed to the bond principal. *Id.* at 141-42. Under the *Pearlman* decision, a payment by U.S. Fire to United Rentals would have resulted in an equivalent secured claim against the estate by U.S. Fire. *See id.* ("since the surety in this case has paid out more than the amount of the existing fund, it has a right to all of it"). United Rentals established at trial that this secured claim held by U.S. Fire would have been fully secured by assets of the estate. As a result, the alleged preferential transfer would not cause any decrease in the estate available for distribution to unsecured creditors relative to the value of the estate that would have been available had the payments not been made.

In response to this argument, the Fourth Circuit reasoned that a court need not determine the actual effect of allegedly preferential transfers on the diminution of the estate. App. 9a-10a. Rather the Fourth Circuit and the lower courts limited their analysis to what United Rentals would have been paid directly from the estate as a general unsecured creditor in the hypothetical Chapter 7 distribution of § 547(b). App. 9a-10a. This analysis is admittedly consistent with the Ninth Circuit's decision in *Committee of Creditors Holding Unsecured Claims v. Koch Oil Company (In re Powerine Oil Company)*, 59 F.3d 969 (9th Cir. 1995). There, Judge Kozinski determined that such a limited analysis was appropriate despite the illogical outcome upon its application. *Id.* at 971, 973 ("Can an unsecured creditor be better off when the debtor defaults rather than paying off the debt? Yes: Law can be stranger than fiction in the Preference Zone").[5]

5. The panel in *Powerine* could not reach a consensus on this very issue. Judge Farris authored a dissent, stating "[t]he plain language of the statute does not limit consideration to funds from the [debtor's] estate." *In re Powerine Oil Company*, 59 F.3d at 974.

Both the Fourth Circuit in reaching its decision in this matter and the Ninth Circuit in *Powerine* turn to a Fourth Circuit decision that does not support their conclusions and is not in conflict with the Sixth Circuit. In *Smith v. Creative Financial Mgmt, Inc. (In re Virginia-Carolina Fin. Corp.)*, 954 F.2d 193 (4th Cir. 1992), much like in the current case, the creditor could have made a claim against a third party for payment of its debt had it not received payment from the debtor. *Id.* at 195. Unlike the current case, that third party would not have anything more than an unsecured claim against the debtor's estate or estate assets. *Id.* at 198. Because holding otherwise would result in a diminishment of the estate available for distribution to unsecured creditors, the *Virginia-Carolina Financial Corporation* court determined that the bankruptcy trustee had met its burden of proof under § 547(b)(5). *See id.* at 199 (stating that the preferential transfer was "at the expense of the debtor's other creditors").

In support of this holding, the *Virginia-Carolina Financial Corporation* court wrote, "[t]he court must focus, not on whether a creditor may have recovered all of the monies owed by the debtor from any source whatsoever, but instead upon whether the creditor would have received less than a 100% payout in [a] Chapter 7 liquidation." *Id.* Both the Fourth and Ninth Circuits have used this language as a basis for analyses that do not consider the actual effect of the transfer on the diminution of the estate but instead require comparison of the transfer to payment as a general unsecured creditor in a direct distribution from the bankruptcy estate. To say that the court must not focus on whether a creditor may have recovered all of the monies "from any source whatsoever," however, does not mean that there is only *one* source of funds shielded from preference attack, a distribution to general unsecured creditors directly from the bankruptcy estate. The critical question instead is whether this particular creditor could have received the same payment in a chapter seven liquidation and whether the estate was diminished by the prepetition transfer. This misapplication of the *Virginia-Carolina Financial Corporation* court's opinion is in direct conflict with precedent of the Sixth Circuit requiring a trustee to establish that a bankruptcy transfer was at the expense of other creditors to be preferential.

The Ninth Circuit in *Powerine* relies on a pre-Bankruptcy Code decision from the Eight Circuit stating that "the key factor in determining whether a payment is a preference is the 'percentage . . . [creditors'] claims are entitled to draw out of the estate of the bankrupt.'" *In re Powerine Oil Company*¸ 59 F.3d at 972 (bracketed material in original) (emphasis omitted). The 1902 decision cited, *Swarts v. Fourth National Bank*, 117 F. 1 (8th Cir. 1902), does not answer the question whether a payment that eliminates the secured claim of a third party is a preference. In fact, there the Eight Circuit extensively analyzed the diminishing effect the preferential transfer had on the debtor's estate. *Id.* at 4-7 (noting that the third party would have an unsecured claim against the bankruptcy estate if called upon to pay the creditor). The statements relied on by the Ninth Circuit are merely an acknowledgment that the transfers were preferential because they would diminish the estate.

The Fourth Circuit cites the late Professor Countryman for the premise that "the court must focus, not on whether a creditor may have recovered all of the monies owed by the debtor *from any source whatsoever*, but instead upon whether the creditor would have received less than a 100% payout in a Chapter 7 liquidation." *In re Virginia-Carolina Fin. Corp.*, 954 F.2d at 199. In turn, Professor Countryman looked to this Court's decision in *Palmer Clay Products Co. v. Brown*, 297 U.S. 227, 80 L. Ed. 655, 56 S. Ct. 450 (1936) for his analysis relied on by the Fourth Circuit. *See* Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 Vand. L. Rev. 713, 735-37 (1985) ("most courts have had no difficulty in reading section 547(b)(5) as incorporating the rule of Palmer Clay Products"); *Palmer Clay Products*, much like *Virginia-Carolina Financial Corporation* and *Swarts*, did not present a conflict between diminishment of the estate and the source of payment. *See generally Palmer Clay Products Co. v. Brown*, 297 U.S. 227, 80 L. Ed. 655, 56 S. Ct. 450 (1936). *Palmer Clay Products* involved a bilateral transaction where the source of the transfers was never a concern. *Id.* at 227-28. In fact, even attempting to use the language of the decision to reach the conclusion by the Fourth Circuit in this case requires a very creative reading of this Court's opinion. *See id.* at 229 ("Whether a creditor has received a preference is to be determined . . . by the actual effect of the payment as determined when bankruptcy results"). The primary issue in *Palmer Clay Products* was whether the analysis of preferential effect was to be made based upon the transfer date or the petition date. *Neuger v. United States (In re Tenna Corporation)*, 801 F.2d 819, 822 (6th Cir. 1986). The source of the alleged preferential payments was not an issue. *See id.*

A question in this case is whether diminution of the estate remains an element of § 547(b) of the Bankruptcy Code and whether the transfer must be compared only to payment as a general unsecured creditor in a direct distribution from the bankruptcy estate. The Sixth Circuit has declared that dimunition remains an element. The Fifth, Sixth, Seventh, Eighth Tenth and Eleventh Circuits similarly continue to apply the concept of diminishment of the estate to § 547(b). The Fourth and Ninth Circuits have found § 547(b) satisfied when the estate would not be diminished by the transfers. This Court should grant the writ of certiorari to resolve this confusion.

B. The decision of the Fourth Circuit conflicts with decisions of the Fifth and Ninth Circuits that an indirect transfer that does not diminish the estate is a valid contemporaneous exchange for new value defense under 11 U.S.C. § 547(c)(1).

The Ninth Circuit considered a remarkably similar case to the current case and reached an opposite result in *O'Rourke v. Seaboard Surety Company (In re E.R. Fegert, Inc.)*, 887 F.2d 955 (9th Cir. 1989) (hereinafter cited as "*In re E.R. Fegert II*"). In the instant opinion, the Fourth Circuit wrote that it had reached its decision "without deciding the correctness of the *Fegert* court's conclusion that the release of the surety's security interest in that case constituted 'new value' contemporaneously received by the debtor." App. 13a. The opinion of the Fourth Circuit, however, does not draw any meaningful distinction between the Ninth Circuit's decision in *Fegert* and the instant case, which are in direct conflict.

In *Fegert*, the debtor contracted with the creditors for the construction of roads. 887 F.2d at 956. Pursuant to the requirements of the Miller Act, the debtor executed a payment bond for the protection of creditors. *Id.* The debtor defaulted on payments to the creditors, causing the creditors to file suits against both the debtor and the payment bond surety. *Id.* Prior to trial, both the surety and the debtor made payments to both creditors and the pending actions were dismissed. *Id.*

After the debtor filed bankruptcy, the trustee filed suit against the creditors seeking to avoid the payments from the debtor as preferential. *Id.* The bankruptcy court granted the creditors' motions for summary judgment based upon 11 U.S.C. § 547(c)(1). *O'Rourke v. Coral Construction, Inc. (In re E.R. Fegert, Inc.)* 88 B.R. 258, 259 (B.A.P. 9th Cir. 1988) (hereinafter cited as "*In re Fegert I*"). On appeal, the Bankruptcy Appellate Panel ultimately affirmed the bankruptcy court. *Id.* at 260. They reasoned that the allegedly preferential transfers released the *contingent* security interest in property of the estate held by the surety. *Id.* This constituted new value under 11 U.S.C. § 547(c)(1) that was released to the estate at the time of the transfers. *Id.*. The Ninth Circuit Court of Appeals affirmed the bankruptcy appellate panel on the same grounds. *In re E.R. Fegert II*, 887 F.2d at 959.

When compared with the current case, the factual similarities are striking. The creditors in *Fegert* and United Rentals in the instant case contracted with a construction contractor on specific construction projects. Both the creditors in *Fegert* and United Rentals in the instant case were valid claimants under payment bonds executed by their debtors. Neither the creditors in *Fegert* nor United Rentals were paid the alleged preferential transfers by the surety. Both the creditors in *Fegert* and the current case were paid by the respective debtors, making payment from the surety unnecessary.

In reviewing the *Fegert* opinion, the Fourth Circuit explicitly noted that a surety does not have an equitable lien until such time as the surety pays the claimant. App. 12a. This is an accurate analysis of *Fegert.* Both opinions make clear that a surety's equitable lien arises *only* upon payment by the surety to the claimants.

The Fourth Circuit then determined that it need not decide the correctness of the Ninth Circuit's decision because of a factual difference in the cases that rendered them distinguishable. App. 13a. This distinction—in the words of the Fourth Circuit—is that the Ninth Circuit reached its conclusion because the allegedly preferential payments in that case caused the "release of the surety's security interest." App. 13a. This statement is shocking, because the Fourth Circuit previously stated that "[t]he Ninth Circuit reasoned that if the debtor had not paid the debt in full, the subcontractors would have been paid by the surety, which *then would have had an equitable lien* against the funds owed the debtor by the owner." App. 12a (emphasis added).

The Ninth Circuit Bankruptcy Appellate Panel in *Fegert I* was explicit in noting that the surety did not have a security interest in property of the estate because the surety had not paid the creditors. It wrote:

> In this case *the surety did not make the payments in question to the subcontractors.* Instead the payments were made pre-petition by the Debtor as part of a tripartite agreement under which the subcontractors released their claims against [the surety] in exchange for payments directly from the Debtor. Under these circumstances, *the Panel does not find that the fact that the surety did not actually make the payments to the subcontractors requires the application of a different equitable rule.* If the Debtor had not made the payments to [the creditors], then [the surety] would have been called upon to advance the funds and then exercise its lien rights against payments due or to become due to the Debtor.

In re Fegert I, 88 B.R. at 260 (emphasis added).

In both the instant case and *Fegert*, the surety did not have an equitable lien against the contract balance for the allegedly preferential transfers at the time of those transfers. Consequently, the purported factual distinction identified by the Fourth Circuit—that "the surety never obtained any lien it could release"—is actually a similarity. If the only relevant question is whether the surety actually possessed an equitable lien to be released at the time of the transfers, the outcome in both these cases would necessarily be the same. In contrast, the outcomes could not be more in conflict. The Fourth Circuit's decision in this case is a wholesale rejection of the *Fegert* decision.

In similar cases, both the Fifth and Ninth Circuits have affirmed the validity of the indirect transfer theory. These cases were both instances where the value of the third party security interest in the property of the estate was contingent upon the possible future enforcement of "mere contract claims" by the preference defendant against that third-party. In *Gulf Oil Corporation v. Fuel Oil Supply & Terminaling, Inc. (In re Fuel Oil Supply & Terminaling, Inc.)*, 837 F.2d 224 (5th Cir. 1988), the Fifth Circuit allowed a contemporaneous exchange defense when the preference defendant had *unsecured contract claims* against a third party bank. *See id.* at 229 (noting that the creditor could have drawn on letters of credit and that the bank had security rights in the debtor's assets based upon those letters of credit). The value of those security rights was contingent upon the preference defendant making a claim against the bank under the terms of the letter of credit. *Id.* The Fifth Circuit assumed that "[u]pon Bankruptcy, had [the debtor] not performed, the [preference defendant] would have drawn on the letters of credit and the Banks would have been entitled to the collateral or its value." *Id.* Because the estate was not diminished by the transfers, the court held that they could not be avoided as preferences. *Id.* at 230.

In *Powerine*, the Ninth Circuit came to the same result. There the court reasoned that there was an "automatic release of collateral."

> The Fifth Circuit held [in *In re Fuel Oil Supply & Terminaling, Inc.]* that the payment was protected by the contemporaneous exchange for new value exception, reasoning that, when

> the debtor paid the creditor, the banks' exposure under the letters of credit was reduced by a corresponding amount. The banks' *contingent* reimbursement claim against the debtor's assets was thereby released, *giving the debtor new value*. "This outcome is consistent with the principle underlying § 547(c)(1)," the Fifth Circuit noted, "*because the release of the debtor's collateral offsets the transfer to the creditor, thereby resulting in no depletion to the debtor's estate*"
>
> . . . When [the debtor] paid [the preference defendant] directly, [the bank's] exposure under the letters of credit was reduced by a corresponding amount, and its *contingent claim* against [the debtor's] assets *was thereby released*, but only to the extent the claim was secured. Thus, [the debtor] received new value equal to the amount of the secured portion of [the bank's] reimbursement claim.

In re Powerine Oil Co., 59 F.3d at 973 (emphasis added).

Much like U.S. Fire's security interest in this case is contingent on U.S. Fire making payment on the payments bonds, in both *Fuel Oil Supply* and *Powerine* the value of the security interest released was contingent on payment by the third party. In all these cases, there never was a payment by the third party because the allegedly preferential payment intervened. Thus, the Fifth and Ninth Circuits have held that transfers which automatically released *mere contract rights* against a third party and caused the simultaneous release of *contingent* security rights of that third party against assets of the estate were not preferential. The decision by the Fourth Circuit in the instant case is in conflict with these decisions by the Fifth and Ninth Circuits.

C. The Fourth Circuit's decision is in conflict with decisions of this Court requiring deference to state courts' determinations of state created lien rights and in conflict with decisions of the Second and Ninth Circuits stating that transfers that release inchoate mechanic's lien rights are not preferential

In reviewing whether a lien created by state law is inchoate, this Court has traditionally accorded great deference to state courts. *See United States v. Security Trust & Savings Bank*, 340 U.S. 47, 49-50 (1950) ("if the state court itself describes the lien as inchoate, this classification is practically conclusive" (internal quotation marks omitted)). The North Carolina Supreme Court has on at least three occasions defined the materialmen and mechanic's liens created by North Carolina statute as "inchoate." *See Frank H. Conner Co. v. Spanish Inns Charlotte, Ltd.* 294 N.C. 661, 667 (1978) ("The lien provided for by G.S. 44A-8 is inchoate until perfected by compliance with G.S. 44A-11 and -12, and is lost if the steps required for its perfection are not taken in the manner and within the time prescribed by law"); *Nat'l Sur. Corp. v. Sharpe*, 236 N.C. 35, 48 (1952) ("G.S. 44-1 gives a contractor an inchoate lien upon a building and the lot on which it is situated"); *Equitable Life Assurance Soc'y v. Dunn*, 234 N.C. 347, 352 (1951) ("A contractor's lien on real property is inchoate until perfected by compliance with legal requirements").

The Fourth Circuit held that United Rentals had only a "right to file a mechanic's lien," with the tacit implication that this "right" is something less than an inchoate lien. App. 16a. As a result, the Fourth Circuit's decision conflicts with the precedent of the North Carolina Supreme Court and ignores the deference to those decisions required by this Court.

This failure to adhere to this Court's precedent and the resulting mischaracterization of United Rentals inchoate liens allowed the Fourth Circuit to circumvent long existing precedent from other circuits. The Second and Ninth Circuits have held that transfer payments that automatically released inchoate mechanic's liens were not preferential. In *Ricotta v. Burns*, 264 F.2d 749 (2d Cir. 1959) as in the instant case, it was conceded that the defendant *could have* filed a mechanic's lien at the time each payment was made. The court noted that:

> neither the filing nor the enforcement of such a lien would have constituted a preference. Moreover, *had the liens been filed*, payment merely discharging them, without improving the creditor's position as against the general creditors of the bankrupt, would likewise have been immune from attack. *It would be absurd to treat differently payments for the same debts obtained without filing liens, and the law does not do so.* Consistent with common sense the courts have upheld payments where at the time the payments were made the

> creditor could have equally protected himself by filing a nonpreferential lien. . . .
>
> The sole purpose of filing these liens is to secure payment. *Surely receipt of payment itself should not be less secure than the lien which could have secured it.* Moreover, the essence of a preference is that it depletes the bankrupt's estate available to remaining creditors. *Where the payment merely avoids the bite of a lien which the trustee could not have successfully attacked, no such depletion occurs.*

Id. at 750 (emphasis added) (internal citations omitted).

In a later case, the Second Circuit reaffirmed this holding stating that "where a material man could have filed liens for building materials furnished the bankrupt and the filing or enforcement of the lien would not have constituted a preference, the court would treat payments for the debts *as if liens had been filed.*" *Miller v. Wells Fargo Bank International Corp.*, 540 F.2d 548, 565 (2d Cir. 1976) (emphasis added).

The Ninth Circuit has similarly held that a transfer made "in discharge of a California inchoate mechanic's lien may not be avoided by the Trustee as a preference." *Greenblatt v. Utley*, 240 F.2d 243, 244 (9th Cir. 1956). The court determined that the preference defendant held an inchoate lien at the time of the transfer, the "filing of which was not required by statute until some time [after the transfer]." *Id.* at 246. Since the time for perfecting defendant's lien had not expired, the defendant accepted the payment "in satisfaction" of inchoate mechanic's lien right and payments were therefore not avoidable as a preference. *Id.* at 244-247.

The Fourth Circuit has rejected and is in conflict with these decisions of the Second and Ninth Circuits holding that there is no preferential transfer if unperfected state law inchoate mechanic's lien rights are released, resulting in no diminution of the estate.

II. The decision below implicates a recurring question of national importance and conflicts with federal and state law

The Fourth Circuit has all but eliminated the protection provided to construction contractors by the federal Miller Act, state law Little Miller Acts or private payment bonds in the event of bankruptcy. A contractor who receives payment from their contract debtor is denied the protections of those statutes or bonds, if that contractor files bankruptcy within ninety days of making payment to their creditor. This result undermines the intent of those statutes and the important public interests that gave rise to their passage.

"The Miller Act was designed to provide an alternative remedy to the mechanics' liens ordinarily available on private construction projects." *J.W. Bateson Co., Inc. v. United States ex rel Board of trustees of the National Automatic Sprinkler Industry Pension Fund*, 434 U.S. 586, 589, 98 S. Ct. 873, 875, 55 L. Ed. 2d 50, 55 (1978); *see also F.D. Rich Co., Inc. v. United States ex rel Industrial Lumber Co., Inc.*, 417 U.S. 116, 122, 94 S. Ct. 2157, 2161, 40 L. Ed. 2d 703, 709 (1974) ("The

Miller Act was intended to provide an alternative remedy to protect the rights of these suppliers."). "The Miller Act . . . is highly remedial in nature." *United States ex rel Sherman v. Carter*, 353 U.S. 210, 216, 77 S. Ct. 793, 796, 1 L. Ed. 2d 776, 782 (1957). "It is entitled to a liberal construction and application in order properly to effectuate the Congressional intent to protect those whose labor and materials go into public projects." *Id.* The Act executes that policy by providing a surety who "must make good the obligations of a defaulting contractor to his suppliers of labor and material." *Id.* at 217. Similarly, state legislatures throughout the country have passed Little Miller Acts with the same intent.

In *Fegert*, the Ninth Circuit considered a contractor who could have collected on a Miller Act payment bond, but was instead paid by the contract debtor who later filed bankruptcy. There the court reached the common-sense conclusion that a creditor should not be prejudiced by its receipt of payment and thus be denied the protections of the Miller Act created by Congress to specifically protect contractors. *See In re E.R. Fegert II*, 887 F.2d at 959 (holding that the payments are not avoidable as preferences).

At least two circuits have held that the reasoning applied by this Court in *Pearlman* applies to non-Miller Act bonds as well. *First Indemnity of America Insurance Company v. Modular Structures, Inc. (In re Modular Structures, Inc.)*, 27 F.3d 72, 80 (3d Cir. 1994) ("There is also nothing in the Court's reasoning in *Pearlman* that implies that its doctrine should apply only to public contracts"); *Framingham Trust*

Company v. Gould-National Batteries, Inc., 427 F.2d 856, 858 (1st Cir. 1970) ("We see no reason why that same equitable obligation to the laborers and materialmen should not exist on the part of the non-government owner, who receives the same benefit from those suppliers — construction work and materials — as did the government in the aforementioned cases.") The instant case does not directly involve a payment bond executed pursuant to the Miller Act or any Little Miller Act, but the reasoning involved is identical. The Fourth Circuit has decided, however, that § 547 eliminates the protection of a bond claimant creditor who received payment of the debt and as a result never made a bond claim, even if the creditor still had bond rights at the time of the transfer and even if the relevant owners and general contractors were holding sufficient funds at the time of the transfer that there was no diminution of the bankruptcy estate available for distribution to general unsecured creditors.

The decision of the Fourth Circuit flies directly in the face of the goals of the preference section of the Bankruptcy Code. These two goals, as expressed by the Fourth Circuit are to prevent companies from "racing to the courthouse to dismember the debtor during his slide into bankruptcy" and to "protect the equality of distribution among the creditors of the debtor." App. 3a (internal quotation marks omitted). The decision of the Fourth Circuit, however, requires construction creditors to race to the courthouse before they actually receive payment, if the creditor wishes to retain their payment bond or state law mechanic's lien rights.

The public policy ramifications of this decision are enormous. To protect themselves, any construction supplier or contractor would need to refuse payment and instead file mechanic's lien or bond claims as an ordinary practice to avoid bankruptcy preference claims, even if there is no reason to suspect an imminent bankruptcy. These mechanic's liens or bond claims would then be released on receipt of payment. This would disrupt projects and business relations, generate legal fees and consume court resources, while promoting, rather than preventing, dismemberment of the debtor during his slide into bankruptcy.

Paradoxically, a debtor that really wanted to avoid paying a certain lien or bond creditor could accomplish that end by *actually paying* the creditor right before bankruptcy.

> The Debtor/Contractor could, in effect, avoid payment of any or all subcontractors by paying them within 90 days of bankruptcy and then simply waiting until 60 days after substantial completion of the work before filing the action to recover the preference. By doing so, the subcontractor could effectively be denied its lien rights.

In re Dick Henley, Inc., 38 B.R. 215 (Bankr. S.D.N.Y. 1984). The *Dick Henley* court recognized that the reasoning applied by the Fourth Circuit creates a legal framework that in reality is itself preferential.

Under the Fourth Circuit decision, an unpaid contractor is unquestionably better off than a paid contractor when a bankruptcy intervenes, where the payment bond or mechanic's lien rights could have been successfully enforced post bankruptcy petition. Consequently, contractors will be forced to take steps to protect their status, even when those actions defy common sense and threaten to wreak havoc on the construction industry. A decision with such clear and severe consequences warrants this Court's review.

CONCLUSION

For the foregoing reasons, United Rentals, Inc., respectfully requests that the Court grant its petition for a writ of certiorari.

Respectfully submitted,

James D. Fullerton
Counsel of Record
Richard I. Hutson
Paul Schrader
Fullerton & Knowles, PC
12642 Chapel Road
Clifton, VA 20124
(703) 818-2600
jfullerton@fullertonlaw.com

Attorneys for Petitioner