

**CASE NO. 07-50803**

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**IN THE UNITED STATES COURT OF APPEALS  
FOR THE FIFTH CIRCUIT**

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**JOHN PATRICK LOWE, TRUSTEE, et al**

**Plaintiffs-Appellants,**

**v.**

**PALMETCO, INC.,**

**Defendant-Appellee.**

**Appeal from the United States District Court for the Western  
District of Texas in 05-CV-0814, Judge William Wayne Justice**

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**BRIEF OF AMICUS CURIAE  
AMERICAN SUBCONTRACTORS ASSOCIATION, INC.  
IN SUPPORT OF APPELLEE, PALMETCO, INC.  
FOR AFFIRMANCE IN PART AND REVERSAL IN PART**

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**SUPPLEMENTAL STATEMENT OF INTERESTED PARTIES**

The undersigned counsel of record certifies that the following listed persons and entities as described in the fourth sentence of Rule 28.2.1 have an interest in the outcome of this case. These representations are made in order that the judges of this court may evaluate possible disqualification or recusal.

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#### AMICUS CURIAE

American Subcontractors Association, Inc.

Pursuant to Fed. R. App. P. 26.1, the full name of the amicus represented is given above. No other real party in interest exists. There is no parent corporation or any publicly held companies that own 10 percent or more of the stock of the amicus curiae. The names of all law firms and the partners or associates expected to appear in this court for the amicus now represented by me are:

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Dated November 28, 2007

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Thomas J. Walthall, Jr.  
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## **STATEMENT OF CONSENT TO FILING**

Pursuant to Fed. R. App. P. 29(a), all parties have consented to the filing of this amicus brief, obviating the need for separate motion. Copies of the signed consents have been forwarded to the Clerk by letter in advance of this brief.

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**STATEMENT OF IDENTITY, INTEREST,  
AND AUTHORITY TO FILE**

The American Subcontractors Association, Inc. (“ASA”), the Amicus Curiae submitting this Brief, is a national organization representing the interests of approximately 5,000 subcontractor member businesses in the United States, including members of five Texas Chapters: Houston, North Texas, San Antonio, Austin, El Paso and the Rio Grande Valley. ASA members include the whole spectrum of businesses including large, midsize and small closely held corporations down to sole proprietorships. These members provide labor and materials on construction projects throughout the United States. Subcontractors perform approximately 80-90% of the work on construction projects.

ASA’s primary focus is the equitable treatment of subcontractors in the construction industry. ASA acts in the interest of all subcontractors by promoting legislative action and by appearing as Amicus Curiae in significant legal action that affects the construction industry at large, such as the position Appellant Patrick Lowe, Trustee, is attempting to advance in this case. The issues raised in the instant appeal profoundly affect ASA’s member companies as well as thousands of Texans who are gainfully employed by these companies. The financial survival of ASA’s member

companies depends on the reasonable, fair, and consistent enforcement of Texas lien and Construction Trust laws.

Counsel for ASA is being compensated for this Brief by ASA.

Authority to file is by agreement pursuant to Fed. R. App. P. 29(a). At the suggestion of the Clerk, signed copies of the parties' consent have been submitted in advance by ASA.

### **SUMMARY OF ARGUMENT**

This case presents issues that are important to the interests of the ASA's Texas membership and the Texas construction industry in general because it affects the security and stability provided to the industry by Texas lien and Construction Trust Fund laws. The lien laws allow deserving derivative claimants like construction subcontractors and suppliers to trap funds they are owed by upstream contractors in the hands of the project owner and perfect liens against the owner's real property to secure payment of the indebtedness. The Construction Trust Fund law provides that payments received by upstream contractors are trust funds that are held for the benefit of downstream subcontractors and suppliers.

The Bankruptcy Court correctly held that Palmetco did not receive more than it would have in Chapter 7 liquidation because it would have trapped funds in the hands of the owner and perfected a lien to secure its

claim. The funds that Debtor N. A. Flash paid to Palmetco were also trust funds. N.A. Flash would have violated its obligations under the Trust Fund Statute by not using those funds to pay bills owed on the Project. In addition to being criminal, nonpayment would not be commercially reasonable.

The District Court erred in part by holding that owner payments of trapped funds and lien claims would be payments from a third party source that do not diminish the Debtor/contractor's estate. To the contrary, according to the Texas lien statutes, owner payments on lien claims come from money otherwise owed to the contractor. Such lien payments come from money that is trapped while held by the owner, and otherwise owed to the contractor. In other words, the payments would be part of and diminish the debtor's estate.

## **ARGUMENT**

### **I. IMPLICATIONS OF THE TRUSTEE'S ARGUMENT**

The construction industry in Texas and throughout the country is based on the flow down of construction funds from the lender to the owner, to the contractor and then to subcontractors and suppliers.

This flow of money is the life blood of the construction economy. The supplier or subcontractor is the industry's key participant who "increases the value of land on credit" and therefore "should have his

security in the land and improvements” because their labor and materials furnished become fixtures, and thus not subject to a security interest, beyond the protection of the lien and Trust funds acts. *Youngblood on Texas Mechanics Liens* § 104.1. The industry relies on the extension of credit by suppliers and subs to build capital improvements. The subs and suppliers rely on the flow down to them of the construction funds, and the lien and trust fund acts are designed to protect such flow of construction money.

The issue presented in this case is extremely important to the Texas construction industry because of its potential disruptive effect to extension of credit in the industry. Allowing the Chapter 7 Trustee to avoid and recover payments to a supplier or subcontractor received on a construction project in Texas dramatically increases the risks to contractors and suppliers who extend credit to other contractors in the Texas construction industry.

The position urged by the Trustee creates a void in the reinforcing system of laws that allow subcontractors and suppliers to secure their claims by trapping funds and perfecting liens. It would empower Chapter 7 Trustees to reach back to recover payments to contractors and suppliers when those contractors and suppliers can no longer perfect liens to recover the payments from the Owner. Such claims by the Trustees would interfere with extension of credit or conferral of “new value,” ostensibly favored by



the Bankruptcy Code. *See Barnhill v. Johnson*, 503 U.S. 393, 402 (1992) (The § 547(c) subsections are designed “to encourage creditors to continue to deal with troubled debtors on normal business terms by obviating any worry that a subsequent bankruptcy filing might require the creditor to disgorge as a preference an earlier received payment”).

## **II. OVERVIEW OF TEXAS LIEN AND CONSTRUCTION TRUST FUND LAW**

A historical overview of Texas mechanic’s lien and construction trust fund law is helpful to the Court’s analysis of why it should not adopt the position urged by the Trustee.

### ***A. Origins of Mechanic’s and Materialmen’s Liens in Texas***

Mechanics lien law is based solely on statutory enactment, and has no predecessor common-law basis.<sup>1</sup> “The liens of mechanics and materialmen, on buildings and land, is a creature of statute, and was unknown either at common law or in equity.” Phillips, *Mech. Liens* (3d Ed.) § 1. Such liens

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<sup>1</sup> The first mechanics lien statute was passed in United States by the Maryland legislature in 1791. George Washington appointed commissioners in 1791 to plan the new city of Washington and establish it as the federal government capital. James Madison and Thomas Jefferson were among the commissioners. The commissioners adopted a memorial in encouraging the Maryland General assembly to pass an act creating a lien for “Master builders” to encourage construction of capital improvements in Washington D.C. *See Moore-Mansfield Constr. Co. v. Indianapolis, N.C. & T. Ry. Co.*, 101 N.E. 296 (Ind. 1913) (discussing history).

were then allowed by the civil law. 1 Domat's Civil Law, by Strahan, §§ 1741, 1742.

The public policy basis for the grant by statute of mechanics liens is based on the premise that contractors should have security. Youngblood on Texas Mechanics Liens § 104.1 (“ . . . one who increases the value of land on credit should have his security in the land and improvements”).

A person who by his labor or material expended on improvements made on the land of another, under contract, express or implied, that this shall be paid for, thereby increases its value, and ought to the extent of the contract price or value of the thing furnished, to have a lien on the land, of which the improvement becomes a part, to secure payment.

*Lippencott v. York*, 24 S.W. 275, 280 (Tex. 1893).

Two types of mechanics lien statutes exist in the United States. The Pennsylvania type allows subcontractors a direct lien on the property and improvements of owners for the full value of their claims irrespective of any remaining balance due from the owner to the original contractor for the particular construction project.

The second type of lien law is like that of New York. In the New York plan, the subcontractor has a lien which is limited to the balance due by the owner to the contractor for the project. In New York type lien statutes the subcontractor is considered to be a “derivative” claimant because the owner's liability to pay the subcontractor's mechanic's lien is limited to, and

derivative of, the indebtedness owed by the project owner to the master builder/general contractor.

Since 1839, when it was still a republic, Texas has adopted the New York type “fund trapping” mechanic’s lien statute which limits owner liability to pay lien claims to the remaining unpaid funds otherwise due the contractor. Youngblood on Texas Mechanics Liens § 102.1.

***B. The Texas Mechanic’s and Materialmen’s Lien Statute as Interpreted***

The current version of Texas materialmen’s lien law is still based on the New York type plan. “It is clear from the framework of Chapter 53 that a materialmen’s lien and the necessary steps a subcontractor must perform to perfect this lien have to do with real property and foreclosure secondarily and the trapping and retainage<sup>2</sup> of funds for the benefit of derivative claimants primarily.” *In re Waterpointe Intl., LLC*, 330 F.3d 339, 344 (5th Cir. 2003). The purpose of the Texas materialmen’s lien statute is to secure payment for those who furnish labor or materials in connection with the construction of improvements to real property to the extent of the increased value of those improvements to the owner’s property. *Id.* at 343.<sup>3</sup>

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<sup>2</sup> Retainage is defined as 10 percent of either the contract price or 10 percent of the value of the work. TEX. PROP. CODE § 53.101(a)(1)-(2).

<sup>3</sup> As remedial statutes, “the mechanic's and materialman’s lien statutes of [Texas] will be liberally construed for the purpose of protecting laborers and materialmen.” *First Nat’l Bank v. Whirlpool Corp.*, 517 S.W.2d 262,

In Texas, a materialmen’s lien, even for derivative claimants (e.g., suppliers who have not contracted directly with the owner of the property to be improved), is a constitutional right. TEX. CONST. art. XVI, § 37 (“mechanics, artisans and materialmen of every class, shall have a lien upon the buildings and articles made or repaired by them for the value of their labor done thereon, or material furnished therefore . . .”).

However, persons not contracting directly with the owner do not have a “self-executing” lien on the owner’s property on which their work or supplies have been incorporated, and must comply with the statutory lien perfection requirements of Chapter 53 of the Texas Property Code to be able to enforce their rights to payment or, if necessary, foreclosure against the owner and his property. *In re Waterpointe Intl., LLC*, 330 F.3d 339, 343 (5th Cir. 2003).

The derivative claimant, however, does not receive a claim against the owner for the full amount of the lien. *In re HLW Enterprises of Texas, Inc.*, 157 B.R. 592, 598 (Bankr.W.D.Tex. 1993) (lien “merely appropriates so much of the money in the owner’s hands as is due or may become due to the

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269 (Tex.1974). “Substantial compliance with the statutes is sufficient to perfect a lien.” *First Nat’l Bank of Graham v. Sledge*, 683 S.W.2d 283, 285 (Tex. 1983).

contractor, to the extent necessary to satisfy [the lien]”), citing *Lonegran v. San Antonio Bank and Trust*, 104 S.W. 1061 (Tex. 1907).

Owner liability to pay the subcontractor lien is limited to (1) the funds that can be trapped at the owner and (2) any retainage. *Lonegran v. San Antonio Bank and Trust*, 104 S.W. 1061 (Tex. 1907) (fund trapping provision has same effect as writ of garnishment and traps only funds owed by owner to contractor); *First National Bank and Graham v. Sledge*, 653 S.W.2d 283 (Tex. 1983) and *Dowdy v. Hale Supply Co.*, 498 S.W.2d 716 (Tex.App.—Fort Worth 1973, no writ) (10% retainage).

“The owner is personally liable for any funds paid to the original contractor in violation of either [the trapping or retainage provisions].” *Stolz v. Honeycutt*, 42 S.W.3d 305, 312 (Tex.App.—Houston [14th Dist.] 2001, no writ), citing *Exchange Sav. & Loan Ass’n. v. Monocrete Pty. Ltd.*, 629 S.W.2d 34, 37 (Tex. 1982). If the owner shows that it paid the funds and retainage prior to the supplier’s perfection of the lien, however, the owner is entitled to release of the lien. TEX. PROP. CODE § 53.160(b)(4)-(5).

Significantly, this Circuit has already held that where an owner pays trapped funds into the registry of a state court to partially satisfy a lien under the Texas materialmen’s lien statute:

***The trustee in bankruptcy acquired no better title to the fund . . . than the bankrupt had at the time the petition was filed. . .***

.The statutory lien was not lost as a result of the contractor being adjudged a bankrupt. . . The effect of the Texas statutes being to transfer the owner's obligations from the bankrupt contractor to the lienholders to the extent necessary to satisfy their liens, and the fund in the registry of the state court being insufficient to discharge the liens in full, ***it follows that there was no money fund deposited in the state court or held by the clerk to which the trustee in bankruptcy had any title or in which he had any interest.***

*Perry v. Wood*, 63 F.2d 257 (5th Cir. 1933) (emphasis added); *see also* TEX. PROP. CODE § 53.160(b)(5) (providing for procedure for extinguishing of materialmen's lien where *all* funds claimed by lien are paid into registry of state court).

The same principles govern this case. The Trustee acquires no greater interest than Debtor N.A. Flash had in the funds that were paid to Palmetco. That money was construction trust funds that Debtor N.A. Flash held in trust for the benefit of Palmetco.

Because Texas is a New York style "fund trapping" state the use of the funds on the Texas construction project is of great import, and lies at the heart of the Property Code scheme for securing subcontractor and supplier lien claimants. Once the funds for the project leave the owner's hands and are paid to the contractor no more owner lien liability remains, and thus claimants thereafter are without a lien remedy against the owner or its property.

Because of the need to protect funds on construction projects after they leave the hands of the owner, the Texas Legislature has enacted two additional protections for subcontractors and suppliers.

***C. Texas Property Code § 53.151***

The first protection enacted by the Texas Legislature is TEX. PROP. CODE § 53.151 which provides that once the construction project funds are paid by the owner to the contractor, all of the contractor's other creditors besides subcontractors and suppliers for that job, may not garnish or enforce a security interest against such funds. *In re Waterpointe Intl, LLC*, 330 F.3rd 339 (5th Cir. 2003).

Compliance with the lien statute requirements enables suppliers to have preferred status over secured as well as unsecured creditors. *See id.* at 347-349. It follows that § 53.151(a) would be given effect against other types of secured creditors not exempt from Chapter 162 when construction trust funds were due to the supplier and where Chapter 53 notice requirements were satisfied.

***D. Texas Construction Trust Funds Act***

The second protection that the Texas Legislature has enacted for the benefit of construction subcontractors and suppliers is the Texas Construction Trust Funds Act ("Construction Trust Fund Act" or the "Act"),

now Texas Property Code Chapter 162. Under the Construction Trust Fund Act, funds paid to a contractor or subcontractor are held in trust for those downstream mechanics, materialmen, artisans and other laborers who have worked on a given construction project. TEX. PROP. CODE § 162.001 et seq. Section 162.001 of the Act provides:

Construction payments are trust funds under this chapter if the payments are made to a contractor or subcontractor, under a construction contract for the improvement of specific real property in this state.

TEX. PROP. CODE § 162.001.

Chapter 162 was enacted to give protection to materialmen in addition to that provided by the materialmen's lien statutes. Because chapter 162 is a remedial statute, courts must give it a broad construction to effectuate its remedial purposes. The purpose of the statute is best served when the statute is read in accordance with its common sense meaning.

*C&G, Inc. d/b/a Fox Rental v. Jones*, 165 S.W.3d 450, 454 (Tex.App.—Dallas 2005, rev. denied), *citing McCoy v. Nelson Utils. Servs., Inc.*, 736 S.W.2d 160, 164 (Tex.App.—Tyler 1987, writ ref'd n.r.e); *In re HLW Enterprises of Texas, Inc.*, 157 B.R. 592, 597 (Bankr.W.D.Tex. 1993).

“The wording selected by the Texas Legislature specifies that a trust fund arises in favor of materialmen if the [construction] payments are made to a contractor or a subcontractor.” *In re HLW Enterprises of Texas, Inc.*, 157 B.R. 592, 596 (Bankr.W.D.Tex. 1993) citing TEX. PROP. CODE



§ 162.002. “Thus, once the owner makes a payment to either the general contractor or to a subcontractor, that payment gives rise to a trust for all parties in the subcontract chain.” *Id.*

The materialmen at the end of the real property owner-contractor-subcontractor-materialmen chain is perhaps most in need of a trust in its favor arising from first payment. Otherwise, the subs and suppliers last in line are most vulnerable to diversion of funds due and owing to them by any one of a number of intermediate parties beyond the ultimate party in direct privity with them.

The materialman is only afforded the protection afforded by the statute if the trust relationship is imposed all the way up the chain to the original contractor once a payment on the construction project is made by the owner, and all the way back down the chain for every one who have worked on the project or supplied materials to the project.

*In re HLW Enterprises of Texas*, 157 B.R. 592, 597-98 (Bankr.W.D.Tex. 1993).

Under the Construction Trust Fund Act, construction payments are “trust funds.” Recipients (i.e., the owner, contractor, and suppliers) are “trustees” for the construction funds which come into their possession. Subcontractors and suppliers which furnish labor or material to improve real property in Texas, are beneficiaries of this “trust fund.” The purpose of this “fund” is to pay for the work or materials.

Diversion of construction trust funds is a violation of the Act. TEX. PROP. CODE § 162.031–.032. The Act provides personal liability for the

controlling persons diverting such funds, and also provides criminal penalties for intentional diversion. *Id.* It is a felony to retain, use, or divert trust funds in excess of \$500.00, unless the trustee has paid all current or past due obligations respecting the trust funds. *Id.* Texas case law provides a private civil action for violation of the Trust Fund Statute. *Lively v. Carpet Services, Inc.*, 904 S.W.2d 868 (Tex.App.—Houston [1st Dist.] 1995, writ denied) and *Tacon Mechanical Contractors, Inc. v. Grant Sheet Metal, Inc.*, 889 S.W.2d 666 (Tex.App.—Houston [14th Dist.] 1994, writ denied).

The Construction Trust Fund Act thus provides an additional and separate remedy over and above the statutory mechanic's lien rights. A claimant can make a claim against, and then sue if necessary, whoever has possession of "trust funds" (construction proceeds), under Tex. Prop. Code § 162.001. This is completely separate from the right to sue on a lien or bond claim, and can be asserted as an additional claim, in the same suit.

This statutory scheme (the mechanic's lien statute, Tex. Prop. Code § 53.151(a), and the Construction Trust Funds Act) makes it clear that the state property law in Texas treats construction funds differently from any other type of property. Texas law envelops construction trust funds and insulates them from claims of unrelated creditors, and controls their use to

pay suppliers and subcontractors, because once they are released by the owner to the contractor, the lien claimant is unprotected.

The Trustee in this case disagrees, favoring a narrower reading of the Act which argues that the Debtor, N.A. Flash, never received construction trust funds.<sup>4</sup> Trustee's brief at 12. The Trustee's reading, while recognized as perhaps "a plausible construction of the trust fund statute," *In re HLW Enterprises of Texas, Inc.*, 157 B.R. at 597, has been rejected as one not favored by the weight of the case law or the practical considerations of the overall statutory structure of protections for materialmen, laborers, contractors and subcontractors. *Id.*

TEX. PROP. CODE Chapters 53 and 162 provide a comprehensive statutory scheme that when properly followed provides stability and security to suppliers who supply construction materials to contractors on credit. The Trustee urges this Court to carve a void in that statutory scheme that will empower Chapter 7 Trustees to avoid and recover construction trust funds payments from suppliers who relied on the payments they received and did not trap funds or perfect liens.

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<sup>4</sup> The Trustee's discussion is misleading, however, because the Bankruptcy court was addressing the hypothetical analysis of whether the funds received *would have* been paid as construction trust funds, and was not addressing an issue where Palmetco bore a burden to trace actual funds. The Trustee does not cite to any cases where tracing is required to construct a § 547(b) hypothetical estate.

**III. PALMETCO WOULD HAVE RECEIVED 100% OF ITS CLAIM BY TRAPPING FUNDS AND PERFECTING LIENS, AND BECAUSE THE FUNDS ARE CONSTRUCTION TRUST FUNDS**

***A. Palmetco Would Have Received 100% of Its Claims Because It Would Have Trapped Funds and Perfected Liens to Secure Payment of Its Claims***

In order to prevail in this preference action the Trustee had the burden of proving that Palmetco received payment from Debtor N.A. Flash that was more than Palmetco would have received in a Chapter 7 liquidation.<sup>5</sup> Both the Bankruptcy Court and the District Court correctly found that the Trustee could not meet this burden. ROA Document No. 47, Transcript of 062805 Ruling at p. 5; ROA Original Pleadings Vol. 1 of 1, p. 69-70 (District Court Opinion).

Commercially reasonable contractors and suppliers that are not timely paid for labor and materials furnished to a project will 1) send lien notices to the Owner and General Contractor which trap funds in the owner's hands (TEX. PROP. CODE §§ 53.056(d) and 53.082), and 2) perfect liens against the real property. The testimony in this case was that Palmetco always perfected liens by sending notices and, if it did not receive payment, filing

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<sup>5</sup> See e.g., *Coral Petroleum v. Banque Paribas-London*, 797 F.2d 1351, 1355-56 (5th Cir. 1986); *In re Trans Marketing*, 1997 WL 336190 (5th Cir.) (cases applying hypothetical liquidation analysis).

lien affidavits. ROA Document No. 47, Transcript of 062805 Ruling at p. 4-5.

Palmetco supplied rebar material that was incorporated into concrete slabs that improved and increased the value of real property. The owners of the real property on which the projects were located hired N.A. Flash to construct concrete foundations. N.A. Flash required suppliers to supply it with materials that are incorporated into the foundations such as reinforcing steel (or rebar) and concrete. The owner received value from the materials supplied and Texas laws grant the suppliers lien rights against the owner and the improved property to ensure that they receive payment.

Palmetco would have been paid 100% of the money it was owed because it would have timely sent trap notices and perfected lien claims on the Projects. *See* TEX. PROP. CODE §§ 53.056(d) (trap notice provision). Those trap notices and liens would secure payment in full to Palmetco because the money to pay Palmetco would be trapped in the hands of the owner. A commercially reasonable owner would not pay Debtor N.A. Flash after receiving a trap notice letter because to do so would subject the owner to multiple liability for the same money. Instead the owner would require that N. A. Flash and Palmetco provide it with releases of indebtedness (also called a Lien Waiver) or releases of lien in exchange for payment of the

claimed amount. The Bankruptcy Court correctly held that Palmetco would have received 100% of its claim because it would have secured its claims with liens that would have ensured payment in full. ROA Document No. 47, Transcript of 062805 Ruling at p. 5.

The problem with the position urged by the Trustee, is that it subjects subcontractors and suppliers, who have released their lien rights, to claims by the Trustee that will be made at a time when the claimants have lost their rights to perfect a lien.

Lien rights must be timely asserted in order to be perfected. Notices of claims must be sent to the owner and original contractor by the 15th day of the third month after each month where labor and materials are furnished. TEX. PROP. CODE § 53.056. The affidavit claiming the lien must be filed with the County Clerk by the 15th day of the fourth month. TEX. PROP. CODE § 53.052(a). Failure to timely send the notice or file the affidavit results in loss of the claimant's lien rights.

Contractors and suppliers are legally required to furnish a release of indebtedness and any lien claimed, upon demand after they receive payment of the indebtedness for labor and materials furnished to the Project. TEX. PROP. CODE § 53.152. A contractor or supplier that has been paid in collected funds has at most ten days to release their indebtedness and their

lien rights after receiving a written request. TEX. PROP. CODE § 53.152. The pre-petition preference period in arms length transactions is 90 days. 11 U.S.C. § 547(b)(4)(A).

In addition to statutory obligations to release the indebtedness and the lien, the contract documents between the owner and general contractor, and general contractor and subcontractors, impose similar duties on most commercial projects.

Texas law also subjects lien claimants to significant liability for filing a lien affidavit at a time when there is no debt to be secured by the lien. Under Chapter 12 of the Texas Civil Practice and Remedies Code, the lien claimant could be held liable to each person injured by the lien for statutory damages in the minimum amount of \$10,000, exemplary damages, injunctive relief, court costs and attorney's fees. *Id.* § 12.002. The claimant is also subject to claims by the State of Texas. *Id.* § 12.003.

***B. The District Court Correctly Ruled That Construction Trust Funds Would Be Paid by a Reasonably Prudent Contractor***

“In constructing a hypothetical chapter 7 case, the court must assume that persons would act in a commercially reasonable and businesslike manner.” *In re ML & Associates*, 301 B.R. 195, 202 (N.D. Tex. 2003).

The nature of the industry is such that the commercial expectations of the parties are defeated when a building

contractor or subcontractor does not use accounts paid to him on a job to pay subcontractors or materialmen. . .

The statutory builders trust is not simply special legislation that the building trades have lobbied through state legislatures. Its justification is that the contractor, subcontractor and materialmen cannot spread their risks in the same way as the grocer or other merchants with many customers. Large quantities of labor and materials may go into a single construction project over a long period of time. A large part of a tradesman's capital may be tied up in a small number of construction projects. There is a substantial risk that a general contractor who goes bankrupt will pull down with him some of his subcontractors and materialmen, as well as cause serious economic loss to the owner.

The construction lender, owner, disbursing agent, contractor, subcontractor or surety company which furnishes a payment bond may not have a direct contractual relationship with a materialman down the line. But courts and legislatures have increasingly found that the parties have an independent legal duty arising from reasonable commercial expectations to see to the proper application of construction funds. In the absence of statute, courts have declared that construction funds in the hands of a contractor are held subject to a constructive trust or an equitable assignment or an equitable lien. Even in the absence of a state builders trust statute, federal bankruptcy courts in a variety of situations have refused to apply the property, preference and statutory liens sections of the Bankruptcy Act to favor unsecured creditors over the equitable claims of subcontractors and materialmen to the proceeds of a construction project in the hands of a bankrupt contractor.

*Selby v. Ford Motor Co.*, 590 F.2d 642, 647-48 (6th Cir. 1979) (internal citations omitted).

The Construction Trust Fund Act imposes penalties for misapplication of trust funds where funds are not used to meet actual expenses of a project.



TEX. PROP. CODE § 162.031–.032. Therefore, contractors like N.A. Flash receive payment for their work as construction trust funds from the owner. Contractors like N.A. Flash must then use the funds they receive to pay their suppliers, like Palmetco, or else violate the Texas Construction Trust Fund Act. For purposes of §547(b)(5), N.A. Flash is presumed to act in a commercially reasonable and businesslike manner. *In re ML and Associates, id.*

As a result, the funds received by N.A. Flash and paid to Palmetco did not give Palmetco more than it would have received in a Chapter 7 case. This is because as construction trust funds the N.A. Flash receipts on Palmetco-supplied projects are required by statute to be paid through to Palmetco.

To hold otherwise, as the Trustee urges in this case, would necessarily assume N.A. Flash would divert construction trust fund money elsewhere, and thereby violate the Trust Fund Act including its criminal sanctions and personal liability for controlling persons. It is similarly unreasonable to assume N.A. Flash would retain construction trust funds received and not pay its supplier, because such acts would also violate § 162.031 of the Act and thus trigger fiduciary obligations under the Bankruptcy Code. *In re Faulkner*, 213 B.R. 660, 667 (Bankr.W.D.Tex. 1997).

The only commercially reasonable and businesslike practice in the Texas construction industry is for contractors and subcontractors to, consistent with the statutory scheme enacted by the Texas Legislature, pay subcontractors and suppliers with the construction trust funds received.

***C. Debtor-Contractor Is a Trustee of Construction Trust Funds for the Benefit of Subcontractors and Suppliers Furnishing Labor or Materials to Project***

“A trustee cannot avoid transfers of property unless the property would have been in the estate and therefore available to the debtor’s general creditors.” *In re Ramba*, 437 F.3d 457, 459-460 (5th Cir. 2006). Section 541(d) of the Bankruptcy Code states:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

“Therefore, there can be no preference when a debtor transfers property in which the debtor has no equitable interest.” *In re Ramba*, 437 F.3d at 460.

When the debtor-contractor receives construction trust funds, it holds legal title only. The downstream suppliers, as beneficiaries, however hold equitable title. *See Parker v. Klochko Equip. Rental*, 590 F.2d 649, 653 (6th Cir. 1979) (holding supplier’s equitable interests in construction trust funds are not part of debtor-contractor’s bankruptcy estate); *U.S. v. Whiting Pools*,

462 U.S. 198, 204 n.8 (1983) (citing § 541(d) for proposition that property in which debtor holds legal but not equitable title becomes part of estate only to extent of legal title).

The general principle that “the trustee in bankruptcy acquired no better title to the fund . . . than the bankrupt had at the time the petition was filed,” still holds. *Perry v. Wood*, 63 F.2d 257 (5th Cir. 1933); *In re Delmoe*, 365 B.R. 124, 128 (Bkrcty.S.D.Ohio 2007); *In re Rerisi*, 172 B.R. 525, 527 (Bkrcty.E.D.N.Y. 1994) (trustee “stands in the shoes” of debtor).

In an example where the debtor-contractor and supplier were paid by joint check, this Circuit held that to the extent a debtor has only a legal interest in a joint check, then those funds contained in the joint check may not be recovered as a preferential transfer. *See Georgia Pacific Corp. v. Sigma Service Corp.*, 712 F.2d 962, 968 (5th Cir.1983) (“If indeed all or part of the money so owed was subject to a constructive trust in favor of the suppliers . . . the bankruptcy court would be required to recognize those equitable interests and, perhaps, the debtor in possession's sole permissible administrative act with regard thereto would be to pay over or endorse the sums due to the beneficial owners of the property”).

Similarly, when contracts say that the owner or another contractor has the right to withhold funds from a Bankruptcy debtor and pay them directly

to subcontractors, those funds are not part of the debtor's estate. *In re C&C Excavating Co.*, 288 B.R. 251, 262 (N.D.Ala. 2002); *In re Arnold*, 908 F.2d 52, 55 (6th Cir. 1990).

**IV. THE DISTRICT COURT ERRED IN HOLDING THAT  
PAYMENTS TO PALMETCO BY PROJECT OWNERS ARE A  
THIRD PARTY SOURCE THAT WOULD NOT DIMINISH  
THE ESTATE**

On most projects, an Owner contracts with an Original Contractor to construct improvements to its real property. The Original Contractor subcontracts portions of the work to various specialty subcontractors. The Subcontractors may, in turn, further subcontract portions of the work to other subcontractors and may purchase materials from suppliers that are incorporated into the Project.

As stated above, subcontractors and suppliers do not have a direct cause of action against the Owner of a Project under the lien statutes unless 1) the Owner fails to withhold money after receiving a trap notice or 2) a lien is perfected on the Property. The money that is trapped in the Owner's hands is money that the Owner would otherwise owe the Original Contractor, who in turn would owe to the subcontractors, and so on. The money trapped in the Owner's hands is NOT money that the Owner owes to the lien claimant but for the Owner's receipt of the trap notice.

Trapping money in the Owner's hands pursuant to TEX. PROP. CODE § 53.056(d) protects both the Owner and Subcontractors and Suppliers. The Owner is protected because if he withholds money after receipt of a trap notice and withholds retainage, his maximum liability is the amount of his contract with the Original Contractor. TEX. PROP. CODE § 53.084; *Page v. Structural Wood Components, Inc.*, 102 S.W.2d 720, 721 (Tex. 2003); *First Nat'l Bank of Graham v. Sledge*, 683 S.W.2d 283, 286 (Tex. 1983). The Subcontractors and Suppliers are secured by these trapped funds and retainage in the Owner's hands.

The trapped funds and retainage are funds the Owner would, but for the lien claim, owe to the General Contractor, in this case the Debtor, N.A. Flash. Thus, the trap imposed by a lien *would* diminish N.A. Flash's estate. Such funds are trapped in the hands of the Owner so that the Owner does not have to pay more than the amount of its contract with the General Contractor. The trapped funds are also construction trust funds held for the benefit of the unpaid supplier.

## V. CONCLUSION

The issues presented in this appeal are critically important to the Texas construction industry. The construction industry relies on extensions of credit by Subcontractors and Suppliers who construct capital

improvements that are vital to the state's economy. Texas lien laws and the Construction Trust Fund Act allow subcontractors and suppliers to secure their claims by (a) trapping funds and perfecting liens as to the construction funds in the Owner's possession; and (b) by affording subcontractors and suppliers the protections of the Construction Trust Fund Act once these construction funds are paid to contractors like N.A. Flash.

Texas law also requires subcontractors and suppliers to release liens when they are paid and provides penalties for liens filed when there is no underlying debt. This statutory scheme provides certainty and stability that the industry relies upon daily. Trustee Lowe asks this Court to destabilize this system by creating a loophole for preference actions by Chapter 7 Trustees.

This Court should not allow the Chapter 7 Trustee to recover or avoid payments to subcontractors and suppliers who would otherwise have been secured claimants—but for releasing or waiving their lien rights upon payment by the contractor who subsequently files bankruptcy. Interception of the funds by allowing the Trustee a preference recovery, without protection of the Texas property statutes described above, removes the incentives for supplier or subcontractor credit extension on construction work and will wreak havoc on the industry. Such preference recovery will

also overrule 168 years (since 1839) of Texas statutory law protections for such funds.

Chapter 7 Trustees and Debtors will have incentives to abuse the loophole Trustee Lowe asks this Court to create. Such preference actions will generate substantial fees for Chapter 7 Trustees. Shrewd debtors could use a preference loophole in Texas construction lien law to recover and avoid payments to subcontractors and suppliers, made with construction trust funds, *after* lien or bond claims are released or waived.

The better approach is for this Court to affirm the District Court's holding that trust funds would have been paid to Palmetco and correct the District Court's error that payments from the Project owners are third-party payments that would not diminish the Debtor's estate.

For the reasons stated herein, ASA urges that the opinion of the District Court be affirmed in part and reversed in part, with judgment remaining in favor of Palmetco.

Dated November 28, 2007

Respectfully submitted,

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**CERTIFICATE OF SERVICE**

I certify that the above instrument has been served on the following, in accordance with the Federal Rules of Civil and Appellate Procedure, on the 28th day of November, 2007:

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