

RECORD NUMBER: 09-1209

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**United States Court of Appeals**  
*for the*  
**Fourth Circuit**

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**UNITED RENTALS, INC.,**

*Appellant,*

– v. –

**JAMES B. ANGELL,  
CHAPTER 7 TRUSTEE FOR PARTITIONS PLUS OF WILMINGTON,  
INC., d/b/a PARTITIONS, INC., d/b/a STORM PROTECTIONS SYSTEMS,**

*Appellee.*

**ON APPEAL FROM THE UNITED STATES DISTRICT COURT  
FOR THE EASTERN DISTRICT OF NORTH CAROLINA AT RALEIGH**

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**REPLY BRIEF OF APPELLANT**

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## ARGUMENT

### **I. PAYMENT ALLEVIATED THE NEED TO PERFECT**

The Trustee properly quotes North Carolina and federal bankruptcy law, but consistently comes to incorrect conclusions from those authorities. These incorrect conclusions are consistently reached and supported only by cases unique to the Eastern District of North Carolina.

The Trustee is in agreement that United Rentals had both mechanic's lien and bond rights by supplying rental equipment to the Debtor on these North Carolina construction projects. The Trustee also agrees that United Rentals mechanic's lien and bond rights would have had priority over the Trustee if those rights had been perfected and enforced. The Trustee argues, however, that since United Rentals never perfected and enforced mechanic's lien and bond rights, United Rentals had no such security rights. In support of this argument, the Trustee cites only *Precision Walls v. Crampton*, 196 B.R. 299 (E.D.N.C. 1996) and its unpublished progeny in the Bankruptcy Court for the Eastern District of North Carolina that are attached as an addendum to the Trustee's Brief.

There is no doubt that a mechanic's lien or bond claimant must perfect those rights, enforce rights and successfully prosecute it's case to judgment before the existence of either mechanic's lien or payment bond rights are finally established.

However, the Trustee ignores the central given fact in any bankruptcy preference case: that payment from the debtor intervened.

The intervening payment made it impossible to perfect, enforce, or successfully prosecute an action to judgment. The payment automatically discharged those mechanic's lien and bond rights, effectively "releasing assets of comparable value to the claims of general creditors." *Small v. Williams*, 313 F.2d 39, 44 (4<sup>th</sup> Cir. 1963).

United Rentals no longer has mechanic's lien or bond rights after payment. We will never see perfection or enforcement after payment. As discussed below, an unpaid supplier would have the right to enforce either mechanic's lien or bond rights post-petition. The Trustee's argument leads to an inexorable, illogical and unsupportable result. The only defendant shielded from a preference attack is the defendant that had actually perfected prior to payment. Any creditor paid during the preference period without perfection must give that money back as a preference, while any creditor unpaid during the preference period still has mechanic's lien and bond rights that can be enforced post-petition.

Another problem with the Trustee's argument is that it does not tell us how far we need to go. The Trustee and *Precision Walls* state that we must actually perfect our mechanic's lien rights to be shielded from a preference attack. Would it not also be necessary to actually enforce with a complaint in state court prior to

payment? How do we know that the mechanic's lien claimant would have enforced its mechanic's lien rights? Does the mechanic's lien claimant need to prove it would have properly enforced, in the correct court, with all necessary parties and allegations? Does the mechanic's lien claimant need to prove it would have hired competent counsel?

The Trustee argues that United Rentals "is not entitled to the presumption that 'it would have'" perfected its claims. Trustee Response Brief at pp. 24. The Trustee's argument on this point centers on perfection. This same argument would apply to enforcement, but the Trustee does not tell us whether a defendant also has to prove that it would have properly enforced these rights or whether counsel would have been adequately prepared at trial to prevail.

Experience and logic tell us that it will be unusual facts that a preference defendant has perfected prior to payment. The preference period is relatively brief, the 90 days prior to bankruptcy, while a North Carolina mechanic's lien need not be perfected until 120 days after the claimant's last work. By definition, the debtor is continuing to make payments during this time. Even fewer claimants will have enforced their mechanic's lien or bond rights within the preference period. A mechanic's lien must be enforced within 180 days of the claimant's last work. A trial determining that the claimant has properly perfected and enforced those rights

and establishing the precise dollar amount due to claimant, will not occur until at least a year after last work.

United Rentals had to give notice of its bond claim within 90 days after last work under the terms of Debtor's Mayfair project subcontractor bond and then file suit within one year after last work. Joint Appx. at 317 (Def. Ex. 8-Mayfaire Payment Bond). The case of bond rights on the Doshier project is even more extreme. There was no need to send any notice under the terms of the Debtor's Doshier payment bond or any statute. Joint Appx. at 311 (Def. Ex. 7-Doshier Payment Bond). This renders meaningless any argument that United Rentals had the burden to prove it would have asserted a "bond claim." The only action United Rentals needed to take was to file suit within the statute of limitations. Still, the Trustee argues that a preference defendant has the burden of proving when it would have asserted a bond claim and that the bond claim "would have been made properly." Trustee Response Brief at pp. 43-44.

The Trustee is absolutely correct that we cannot know whether claims would have been properly perfected or enforced. The reason we will never know is that payment intervened. Payment must alleviate the need to perfect or enforce or to prove that either would have been done properly. Asking the Defendant to prove what would have happened without payment is an impossible burden. In any event

this burden would be with the Trustee and not the Defendant, as either mechanic's lien or bond rights would establish the Defendant as a secured creditor.

The same facts presented themselves in Supreme Court of North Carolina case *McCoy v. Wood*, 70 N.C. 125 (1874), discussed below, which has still not been adequately addressed by the Trustee. The *McCoy* court determined that a laborer with unperfected inchoate lien rights did not need to return a payment received, without discussion of whether that laborer would have correctly perfected or enforced those rights.

The allegedly preferential Transfer made it impossible to perfect or enforce mechanic's lien or bond rights and must alleviate the need to perfect or to prove that the defendant would have perfected absent payment. The correct question must be whether the defendant had mechanic's lien or bond rights superior to the trustee at the time of payment, which could have been perfected and successfully enforced either pre or post-petition and which would have resulted in the same payments despite the bankruptcy, all without diminishing the bankruptcy estate for the benefit of general unsecured creditors.

## **II. UNITED RENTALS COULD HAVE PERFECTED AND ENFORCED ITS LIEN AND BOND RIGHTS POST BANKRUPTCY**

The Trustee is just plain wrong when he asserts that United Rentals would have been stayed from enforcing its Lien on Funds rights or mechanic's lien rights in real property post-petition.

It is worthy of note that the Trustee does not take the position that United Rentals' payment bond rights would have been stayed by the bankruptcy, apparently conceding that United Rentals' could have enforced it's bond rights and the bonding company could have enforced it's subrogation rights post-petition.

The Trustee initially limits his argument to the Lien on Funds, citing as his lone authority another unpublished opinion from the same bankruptcy judge as the instant case. *See* Trustee Response Brief, *Addendum, In re Shearin Family Investments, LLC*, Case No. 08-07082-8-JRL (Bankr. E.D.N.C., April 17, 2009).

The Court did find in the *Shearin* case that a claimant was stayed by a bankruptcy petition from making a claim pursuant to the Lien on Funds statute N.C. Gen. Stat. § 44A-18. *See* Trustee Response Brief, *Addendum, In re Shearin* at pp. 6. It is respectfully submitted, however, that the Court's decision in *Shearin* ignores the word "theretofore" in the Lien on Funds statute. According to N.C. Gen. Stat. § 44A-22, Liens on Funds have:

priority over all other interests or claims *theretofore* or thereafter created or suffered in the funds by the person against whose interest the lien upon funds is asserted, including, but not limited to, liens arising from garnishment, levy, judgment, assignments, security interests, and any other type of transfer, whether voluntary or involuntary.

N.C. GEN. STAT. § 44A-22 (2009) (Emphasis added).

The *Shearin* Court and the Trustee are both correct that a Lien on Funds is prospectively "perfected upon the giving of notice of claim of lien upon funds in

writing to the obligor. . . . and shall be effective upon the obligor's receipt of the notice." See Trustee Response Brief, *Addendum, In re Shearin* at pp. 4. Again, there is no question that Lien on Fund rights must be properly perfected and enforced or the lien rights are "lost." However, N.C. Gen. Stat. § 44A-22 makes it clear that once perfected, the Lien on Funds claim has priority over the Trustee, in the position of a judgment lien creditor as of the bankruptcy petition date. Any other reading renders the word "therefore" meaningless and conflicts with the long-held tenet of statutory interpretation that "every word must be given its proper effect and weight." *North Carolina v. Beck*, 359 N.C. 611, 618 (2005) (quoting *Nance v. Southern Railway*, 149 N.C. 366, 371 (1905)).

The Lien on Funds claim, if properly perfected and enforced, has absolute priority over this particular receivable, subject only to the rights of similarly situated Lien on Funds claimants. This is familiar ground in considering the intersection between state law security interests and bankruptcy law. An analogy would be the purchase money security interest, whether perfected before or after the bankruptcy petition See e.g. *In re Yobe Electric, Inc.*, 30 B.R. 114, 116-19 (Bankr. W.D. Pa. 1983) (comparing purchase money security interests to inchoate statutory liens). The bankruptcy estate would not own this asset, absent this extension of credit. This creditor must perfect and enforce, but will have absolute priority to this property in bankruptcy.

Pursuant to this “theretofore” language, the Lien on Funds “relates back” in the same manner as the lien on property. Even if it did not expressly relate back, it would invoke the relation back doctrine discussed in *Equitable Life Assurance Society v. Basnight*, 234 N.C. 347, 351 (1951) where the North Carolina Supreme Court stated that the relation back doctrine:

is inherent in the very statutes which give the contractor the lien upon the property improved by his labor or materials, and allow him six months after the completion of the labor or the final furnishing of the materials in which to claim it; for it is plain that unless the contractor's lien when filed relates back to the time at which the contractor commenced the performance of the work or the furnishing of the materials, the object of the statutes can be defeated at the will of the owner of the property, by his selling or encumbering his estate. To hold that the doctrine of relation back is not inherent in these statutes would be to "keep the word of promise to our ear, and break it to our hope."

*Id.* (Citations omitted).

Similarly, a property owner, general contractor or first tier subcontractor could defeat the Lien on Funds by making payment. The Trustee may be correct that the amount of the Lien on Funds claim is dependant upon the status of accounts after the notice is sent. However, the claim cannot be stayed in bankruptcy. In the instant case, since payment intervened and made it impossible to send a Lien on Funds notice, the status of accounts must be determined as of and after the date of payment.

It is worthy of note that the *Shearin* decision is very recent, dated April 17, 2009. Interestingly, the *Shearin* court did state that a post-petition claimant was not stayed from perfecting a lien on real property, because of Bankruptcy Code § 362(b)(3) “which allows perfection of a lien to (relate-back) to the time of lien creation.” See Trustee Response Brief, *Addendum, In re Shearin* at pp. 3. However, the Trustee goes on to argue inexplicably that the *Shearin* decision would also apply to stay United Rentals lien on real property rights post-petition. The Trustee’s stated reasoning is that “under N.C.G.S. §44A-23, a Subcontractor must give notice of a claim of lien on funds to enforce the Contractor’s lien” and that “if a lien on funds is stayed pursuant to Code §362, the subrogated lien rights of subcontractors under N.C.G.S. §44A-23 are also stayed.” See Trustee Response Brief at pp. 19. However, the Supreme Court of North Carolina has already ruled otherwise.

The legislative intent in the Lien on Funds statute was to continue the subcontractor’s separate right to a lien on real property, not to replace or eliminate the Lien on Funds. *Electric Supply Co. v. Swain Electric Co.*, 328 N.C. 651, 403 S.E. 2d 291, 297 (1991). The North Carolina Appellate Court has long recognized that a lien in favor of a subcontractor may arise either directly under the Lien on Funds statute or by subrogation under the lien on property statute. *Watson Elec. Constr. Co. v. Summit Cos., LLC*, 160 N.C. App. 647, 587 S.E.2d 87, 91 (2003).

Accordingly, no matter what the status of United Rentals' Lien on Funds claim, it could have perfected and enforced its lien on real property on the Mayfaire project post-petition, such that the Transfers and discharge of lien rights placed United Rentals in no better position than it would have been in a hypothetical Chapter 7 and the estate was not diminished.

Federal courts have consistently determined that a claimant has the right post-petition to perfect a mechanic's lien in states with an inchoate lien (that relates back). *H.T. Bowling v. Bain (In re Bain)*, 64 B.R. 581 (W.D.VA. 1986). Both the bankruptcy court for the Eastern District of North Carolina in *Shearin* and the bankruptcy court for the Middle District of North Carolina have come to the conclusion that a North Carolina mechanic's lien will survive a bankruptcy petition. *See Schafer v. Carolina Kitchen & Bath, Inc. (In re Orndorff Constr.)*, 394 B.R. 372 (Bankr. M.D.N.C. 2008).

Pursuant to Section 362(b)(3), a bankruptcy petition "does not operate as a stay . . . of any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee's rights and powers are subject to such perfection under Section 546(b)." An action to perfect a materialman's lien is excepted from the automatic stay by Section 362(b)(3). *Richardson Builders*, 123 B.R. at 738; *Victoria Grain Co. of Minneapolis v. Janesville Elevator Construction, Inc. (In re Victoria Grain Co. of Minneapolis)*, 45 B.R. 2, 6 (Bankr. Minn. 1984) . . . But Section 546(b)(1) and (2) limit the trustee's ability to avoid liens pursuant to Sections 544 and 545. Section 546(b)(1)(B) provides that "[t]he rights and powers of a trustee under §§ 544, 545 and 549 of this Title are subject to any generally applicable law that provides for the maintenance or

continuance of perfection of an interest in property to be effective against an entity that acquires rights in such property before the date in which action is taken to effect such maintenance and continuation." **Chapter 44A of the North Carolina General Statutes is such a statute.** See Cook, 384 B.R. at 288 (state mechanics' lien law is "generally applicable law" within the meaning of § 546(b)).

*In re Orndorff Constr.*, 394 B.R. at 375-76. (Emphasis added).

Interestingly, the *Orndorff* court also states that "under North Carolina law, an action to enforce a materialman's lien must be filed within 180 days after the last furnishing of labor or materials, or the lien is "discharged." *Id.* at 373. The Court also later states that the enforcement action pursuant to N.C. Gen. Stat. § 44A-13 "continues the perfection of the lien which will be 'discharged' unless such an action is timely filed." *Id.* at 379. This "discharge" language certainly implies that the claimant had a lien until the time for an action had expired and is similar to the statement in *Frank H. Conner Co.* cited by both the Trustee and the *Precision Walls* case that a lien is "lost" if not timely perfected. See *Frank H. Conner Co. v. Spanish Inns Charlotte, Ltd.*, 294 N.C. 661, 667, 242 S.E.2d 785 (1978); *Precision Walls v. Crampton*, 196 B.R. 299, 303 (E.D.N.C. 1996).

The District Courts for the Eastern and Western Districts of Virginia have concluded that it was perfectly proper for a claimant to perfect a lien subsequent to the bankruptcy petition filing. See *Concrete Structures, Inc. v. Tidewater Crane and Rigging Co. (In re Concrete Structures, Inc.)*, 261 B.R. 627, 640-41 (E.D.Va. 2001); *In re Bain*, 64 B.R. at 583; See also 98 A.L.R. 32. The mechanics' lien

arises from the contract and exists, as an inchoate right, upon performance of the work. In *In re Concrete Structures, Inc.*, the court affirmed established principles outlined in *In re Bain* that “the recording of a memorandum of lien does not violate the stay imposed by § 362(a). *Id.* at 640; *See In re Bain*, 64 B.R. at 583.

In the state of Pennsylvania, the “filing of mechanic's lien against debtor who has filed Chapter 11 petition for work performed for debtor prior to filing of petition does not violate the automatic stay provisions of 11 USCA § 362.” *Yobe Elec. Co., Inc. v. Graybar Elec. Co., Inc. (In re Yobe Elec., Inc.)*, 728 F.2d 207, 208 (3d Cir. 1984). In Arkansas, the bankruptcy court found that pursuant to the relation back provision of the mechanic’s lien, a properly perfected mechanics' lien on debtors' property was entitled to relief from automatic stay in order to exercise its rights in debtors' property. *In re McCord*, 219 B.R. 251, 253-53 (E.D. Ark. 1998). In Alabama, the bankruptcy court found that a party “could maintain and perfect its mechanics' lien outside bankruptcy and without automatic stay relief.” *In re Cook*, 384 B.R. 282, 288 (N.D. Ala. 2008).

If United Rentals had not received the Transfers that made perfection and enforcement of its lien rights impossible, United Rentals could have perfected and enforced its mechanic’s lien and bond rights after the bankruptcy petition was filed. How can an unpaid supplier be better off than a paid supplier after a bankruptcy petition? A construction supplier or subcontractor that had not been

paid could still file its mechanic's lien or bond claim post petition (and be entitled to full payment if the security had sufficient value). If a construction supplier or subcontractor had the misfortune of being paid before a bankruptcy petition, however, they would no longer have a mechanic's lien or bond claim and would have to repay any funds received.

### **III. THE TRUSTEE STILL HAS NOT ADDRESSED MCCOY V. WOOD**

The Trustee attacks United Rentals' reliance on *McCoy v. Wood*, 70 N.C. 125 (1874) by citing *Eason v. Dew*, 244 N.C. 571 (1956), stating that the North Carolina Supreme Court "limit[ed] the effectiveness of *McCoy v. Wood* in light of the enactment of [N.C. Gen. Stat.] § 42-15." See Trustee Response Brief at pp. 16. This argument is analytically dishonest.

Despite two cites to *McCoy* in *Eason*, the North Carolina Supreme Court's opinion in the *Eason* case is irrelevant to the case at bar. N.C. Gen. Stat. § 42-15 expressly created a superior lien on behalf of a property owner/landlord that could not be displaced by the laborer, regardless of the actions of the laborer. N.C. GEN. STAT. § 42-15 (2009). Pursuant to the terms of N.C. Gen. Stat. § 42-15, the property owner/landlord possessed a statutory lien on the crops, preferred to all other liens, until such time as all rents are paid by the tenant. *Id.*

The North Carolina Supreme Court's opinion in *Eason* did not speak to the effect of payment on an inchoate lien. See generally *Eason v. Dew*, 244 N.C. 571

(1956). It did not speak to the priority of an unperfected inchoate lien. *See generally id.* It did not speak to anything even peripherally relevant to the case before this Court. *See generally id.*

Seemingly, the Trustee is making the argument that *McCoy v. Wood*, is bad law based on the statement in *Eason* that “[i]t is noted that *McCoy v. Wood*, supra, and *Warren v. Woodard*, 70 N.C. 382, cited by appellant, were decided prior to statutory amendments now incorporated in G.S. 42-15.” *Id.* at 575. This statement is true, as N.C. Gen. Stat. § 42-15 created an entirely new lien on behalf of the property owner/landlord that did not exist at the time of *McCoy*. *Id.* The changes to § 42-15 do not, however, affect the application of *McCoy* to the current case. There is no statutory equivalent to § 42-15 in Chapter 44A.

Moreover, the enactment of N.C. Gen. Stat. § 42-15 clearly did not make *McCoy v. Wood* bad law. Subsequent to the enactment of N.C. Gen. Stat. § 42-15, *McCoy v. Wood* was cited affirmatively on numerous occasions by the North Carolina Supreme Court and once by this Court. The Trustee simply has no response to the *McCoy* decision that supports his position. The North Carolina Supreme Court’s decision in *McCoy v. Wood* remains not only good law, but the controlling law in this matter.

**IV. THE TRUSTEE HAD STILL NOT ADDRESSED UNITED RENTALS' BOND CLAIMS**

The Trustee is also apparently in agreement with most of United Rentals' arguments regarding its bond claims, other than the Trustee's assertion that United Rentals must prove it would have immediately enforced its bond rights absent payment and his "micro-preference" or valuation arguments, both discussed below.

It is worthy of note that the Trustee did not take the position that United Rentals would be stayed after the bankruptcy petition from making a bond claim or enforcing those rights. The bonding company is not the debtor in bankruptcy and rights against the bonding company are not affected. The Trustee also apparently accepts that the bonding company's equitable rights of subrogation to the Debtor's contract balances held by the general contractors would survive bankruptcy and have priority over the Trustee.

Instead, the Trustee shifts away from United Rentals' arguments regarding the bonding company's equitable lien rights and argues "[t]here is no North Carolina case that establishes an equitable lien in favor of a subcontractor similarly situated to the Defendant...." *See* Trustee Response Brief at pp. 35. The Trustee cites here and multiple other times in his Brief, this Court's decision in *Grochal v. Ocean Technical Serv. Corp. (In re Baltimore Marine Ind.)*, 476 F. 3d 238 (4th Cir. 2007).

First, United Rentals does not argue in this appeal that it had an equitable lien on any unpaid contract balance owed to the Debtor by the general contractors. It is the Bonding Companies that held an equitable right to “make demand and to receive any balances due under the contracts, to the extent of such balances or to the extent of the payments so made....” *Western Cas. v. Brooks*, 362 F.2d 486, 492 (4th Cir. 1966).

Further, while this Court is certainly in the best position to interpret its decision in *Grochal*, it is respectfully submitted that the Trustee misinterprets this Court’s decision. This Court did not hold that a subcontractor has *no* equitable interest in any unpaid contract balance owed to general contractors. This Court did hold that the subcontractor did not have an equitable interest *equivalent* to that of the surety and that the subcontractor did not have an *absolute* right to the funds. *Grochal*, 476 F. 3d at 240-42. This Court then vacated the judgment and remanded the case to the bankruptcy court for further evidence to determine the nature of the subcontractor’s equitable interest in the funds. *Id.* at 243.

On remand, the bankruptcy court will have to examine the facts of the case at hand to determine if there is any basis for finding that OTS has a similar equitable interest. The court will also have to determine how that interest is treated under the Bankruptcy Code. See, e.g., 11 U.S.C.A. §§ 506, 507, 510 (West 2006) (governing secured interests, priorities, and subordination). These questions -- involving rights and equities under the Bankruptcy Code -- are best determined in the first instance by the bankruptcy court.

*Id.*

The Trustee also cites *Reliance Ins. Co. v. U.S. Bank, N.A.*, 143 F3d. 502 (9th Cir. 1998) for the proposition that even the Bonding Companies had no equitable lien of subrogation until the Debtor had defaulted. United Rentals acknowledges this case and the other authorities cited for this principle. However, if the Debtor had not paid United Rentals with the transfers, the Debtor *would have been in default* and United Rentals *would have* had its bond claims. It should also be noted that these authorities concern a different factual and legal issue: when does the bonding company's equitable rights intervene to give the bonding company priority over other claimants to the fund owed the Debtor?

This Court has held that bonding company's equitable right to these funds relates back to the date of the Bond and it entitles the bonding companies "to priority in payment over all subsequent lienholders and general creditors." *Western Cas.*, 362 F.2d at 490. By the bonding company "'acquiring this equitable interest in retained funds,' those funds become the property interest of the surety and *never become a part of the bankruptcy estate* 'to be administered, liquidated, and distributed to general creditors of the bankrupt.'" *See id.* (quoting *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 136, 83 S. Ct. 232, 234, 9 L. Ed. 2d 190 (1962)) (Emphasis added).

The Trustee has not addressed this authority from the Fourth Circuit, nor has he addressed the decision by the Bankruptcy Court for the District of Maryland

that where the collateral held by the indemnified bonding company is “sufficient to fully secure the claim of the creditor receiving or benefiting from the questioned transfer, the creditor is placed in no better position than it would have been in a hypothetical liquidation under Chapter 7.” *Field v. Insituform East, Inc. (In re Abatement Environmental Resources, Inc.)*, 307 B.R. 491, 500 (Bankr. D. Md. 2004).

## V. THE INDIRECT TRANSFER THEORY

The Trustee does accept the viability of the “indirect transfer’ theory with respect to United Rentals’ bond claims and that the same analysis would apply to lien claims. *See* Trustee Response Brief at pp. 42-43.

Research has not revealed any case in which this Court considered the “indirect transfer’ theory, although several courts within this circuit have, including the *In re Abatement* court. *See also In re J.A. Jones, Inc.*, 361 B.R. at 102, n. 7 (citing *In re Mason and Dixon Lines, Inc.*, 65 B.R. 973, 979 (Bankr. M.D.N.C. 1986)); *In re GEM Constr.*, 262 B.R. 638, 646-47 (Bankr. E.D. Va. 2000).

It is the indirect transfer theory that discredits the Trustee’s reliance on *Smith v. Creative Fin. Mgmt., Inc. (In re Virginia-Carolina Fin. Corp.)*, 954 F.2d 193 (4th Cir. 1992). When United Rentals states that a pre-petition payment to a secured creditor of the debtor is not preferential under *Smith v. Creative Financial*

*Management, Inc.*, the Trustee states “Defendant’s application of this rule is misleading. *Smith v. Creative Financial Management, Inc.*, itself qualifies this statement by holding that a creditor is ‘secured’ only to the extent of the value of his interest in property of the estate.” See Trustee Response Brief at pp. 28.

It is certainly true that a creditor is ‘secured’ under Bankruptcy Code only to the extent of the value of security property in the estate. In *Smith v. Creative Financial Management, Inc.*, however, the debt paid with the preference transfer was collateralized by a promissory note from a non-debtor and secured in non-debtor property. See *Smith v. Creative Financial Management, Inc.*, 954 F.2d at 195-96. In other words, the transfer did diminish the bankruptcy estate, even though the defendant could accurately state that it was fully secured (in non-debtor property) and would have been paid in a Chapter 7 liquidation.

The essence of the indirect transfer theory is that United Rentals could obtain payment either from the property owners, the general contractors or the bonding company. These entities were then secured by property of the estate, such that the Transfers to United Rentals “had the effect of releasing assets of comparable value to the claims of general creditors.” *Small v. Williams*, 313 F.2d 39, 44 (4th Cir. 1963). The Transfer payments are not preferential because “they do not deplete the debtor’s estate or diminish the assets available for distribution among general creditors.” *Id.*

*Smith v. Creative Financial Management, Inc.*, supports United Rentals' position and not the Trustee's when it explained that a secured creditor would be paid, if not by the debtor's pre-petition transfer, then out of its collateral. *See Smith v. Creative Financial Management, Inc.*, 954 F.2d at 198-99. A pre-petition transfer on a secured debt eliminates one debtor asset (transferred property), but simultaneously augments another (by increasing debtor's equity in the collateral). *Id.* at 199.

It should also be noted that in the case of a mortgage lender or any other secured creditor, any trustee could make the same argument as this Trustee that the secured creditor must prove that it would have properly enforced its security rights to obtain payment. However, there is no known case of any trustee trying to make this argument. The payment automatically discharges the security right. "[E]very payment made by the debtor increases the debtor's equity in the collateral, thereby proportionally enhancing the value of the bankruptcy estate." *Id.*

## **VI. MICRO PREFERENCE AND VALUATION ARGUMENTS**

The Trustee is correct when he states that the Lien on Funds statute "calls for pro-rata distribution among holders of 'valid claims of liens upon funds that have been received by the obligor' and 'the amount of the valid claims of liens on real property upon the owner's property filed by the subcontractors.'" *See* Trustee Response Brief at pp. 28. The Trustee raises a legitimate factual issue in both lien

cases and bankruptcy preference cases and which was the subject of discussion at trial.

The issues we are left with are the proper burden of proof and the question of timing of the valuation. As discussed at length in United Rentals initial brief, the Trustee has the burden of proof, as United Rentals would have received the same payment in a Chapter 7, (indirectly) from the assets of the estate. The question of valuation is not an issue at this point on appeal, in as much as Trustee submitted no evidence at Trial that there were competing claimants for the same funds.

The proper timing for the valuation of those security rights would be as of the date of the bankruptcy petition, as is also discussed at length in United Rentals initial brief. *See* United Rentals Opening Brief at pp. 49. United Rentals put on ample proof at trial of the value of security property, the monies owed to the debtor and paid to the debtor both at the time of the transfers and in the time following up to the petition date. *See* United Rentals Opening Brief at pp. 6-8, *Status of Account Summary*. Although the Trustee had the burden of proof and presented *no* evidence, United Rentals affirmatively established the value of the collateral.

To the extent that United Rentals must proceed on a contemporaneous exchange theory, both the burdens and the timing of the valuation change. The valuation of the new value would be at the time of the transfer. *See Committee of*

*Creditors Holding Unsecured Claims v. Koch Oil Company (In re Powerine Oil Company)*, 59 F.3d 969, 973 (9th Cir. 1995). Again, United Rentals put on ample evidence of the value of its Lien on Funds and lien on real property rights as of the date of the transfer, in the form of dollar amounts owed to the debtor at that time. See United Rentals Opening Brief at pp. 6-8, *Status of Account Summary*.

The question of whether there are other claimants to these same funds is a legitimate issue at this point also. It is respectfully submitted, however, that cannot be United Rentals' burden to prove that there are *no* other claimants to these funds. First, it is always impossible to prove a negative, that there are *no* other claimants. Second, this information is peculiarly in the Trustee's, and not United Rentals' possession. The Debtor knows what other subcontractors and suppliers it hired on the project, the dollar amount owed to them and the dollar amount the Debtor claimed due from each owner or general contractor. It is difficult or impossible for a preference defendant to get this information, except from the Debtor. In the instant case, this information was requested from the Trustee in written discovery without response. The Trustee cannot complain at this point that United Rentals failed to prove that there were no other claimants to the funds.

To the extent that United Rental's ever had the burden of proof on the question of valuation, that burden shifted back to the Trustee once United Rentals

presented evidence that the general contractors on each project were holding sufficient funds and that the estate was not diminished by the Transfers.

## **VII. NEW VALUE ARGUMENTS**

Trustee states that the “implicit ‘release’” of Defendant’s lien or bond rights is not new value. *See* Trustee Response Brief at pp. 40. The release was not “implicit.” The transfers *discharged* United Rentals lien and bond rights as a matter of law, contemporaneously increasing the debtor’s equity in the monies held by the owners and general contractors on the projects. The absence of written releases is irrelevant for the same reason. The *Jones* case did state as a matter of stipulated fact that the Defendants had provided written releases, but states nowhere that this was an essential element or a factor in the decision.

Evidence regarding what United Rentals would have immediately done absent payment is also irrelevant for the same reason. The transfers automatically and contemporaneously increased the assets of the debtor.

The new value debtor’s received was *money* received from the general contractors after the transfers. While the debtor did not transfer property to United Rentals, United Rentals acquired security rights by supplying rental equipment and those security rights were transferred to the Debtor in exchange for the Transfers. *See* Trustee Response Brief at pp. 41.

### **VIII. DIFFERENCES IN STATE LIEN LAWS**

There is no question that lien laws vary from state to state and that this may alter the result in bankruptcy preference cases.

One example would be states such as Florida or California, which require a “Notice to Owner” before or soon after beginning work on a project in order to ever have lien rights.

The critical difference for our purposes, however, is whether the state has inchoate lien rights which relate back to the time work began. A striking example of a state without inchoate lien rights in this circuit is Maryland. Maryland formerly had an inchoate lien law until the statute was dramatically revised by the legislature. Since that time, a claimant has no lien in Maryland until the court enters a final order establishing the lien. *Mervin L. Blades & Son, Inc. v. Lighthouse Sound Marina & Country Club*, 37 Md. App. 265, 269-70 (Md. Ct. Spec. App. 1977). Maryland’s mechanic’s liens “were transformed into little more than debt claims” and now have essentially the same priority as a judgment lien. *Id.* at 266. In other words, the Trustee’s arguments with respect to mechanic’s liens would be correct if we were in Maryland. A bankruptcy by a property owner would stay any attempt to establish a lien and will effectively eliminate mechanic’s lien rights.

It is striking that the Maryland legislature revised its lien law because Maryland's highest court had found it unconstitutional as a taking of property without due process. *Barry Properties v. Fick Bros. Roofing Co.*, 277 Md. 15, 352 A.2d 222 (Md. 1976). The *Barry* court stated that “[u]nder the terms of the Maryland statute, *a lien is created and attaches* to the property as soon as work is performed or materials are supplied . . . and lasts until ‘the expiration of 180 days after the work has been finished or the materials furnished, although no claim has been filed for them [with the clerk of the court].’” *Id.* at 225-226 (Citations omitted) (Emphasis added). The court also stated that “. . . there is a ‘subsisting lien’ as soon as materials are supplied or work is performed . . .” and that “[w]hen timely filed, the claimed lien *additionally* becomes an encumbrance of record,” *not* that the lien comes into being or attaches at the time of perfection. *Id.* at 228 (Citations omitted) (Emphasis added).

The mechanic's lien laws of the various United States generally have a common genesis, particularly in the mid Atlantic region. Maryland actually passed the nation's first mechanic's lien law in 1791 “at the urging of [two Virginians] Thomas Jefferson and James Madison, to facilitate the speedy construction of the new capital city of Washington.” *Id.* at 224. The inchoate nature of the mechanic's lien is still a constant feature in the mid Atlantic region

outside of Maryland, including Pennsylvania, Virginia, West Virginia, and both Carolinas.

The authorities discussed in United Rentals' initial brief, particularly the statute itself, *Conner*, and *McCoy* establish that the North Carolina mechanic's lien is inchoate and shall "relate to and take effect from the time of the first furnishing of labor or materials." N.C. GEN. STAT. § 44A-10. A North Carolina mechanic's lien is similarly "*discharged*" "[b]y failure to enforce the claim of lien on real property within the time prescribed by this Article." N.C. GEN. STAT. § 44A-16 (2009) (Emphasis added).

While the Trustee correctly points out that there *can* be differences in state mechanic's lien law that could cause varying results in bankruptcy preference cases, he has not identified any difference in the North Carolina statute that would make the bankruptcy authorities cited by United Rentals inapplicable.

The Trustee also argues that the North Carolina has not amended their mechanic's lien statute in the twelve years since *Precision Walls*, but this argument is also not helpful. *Precision Walls* just plain incorrectly interpreted the North Carolina mechanic's lien statute. There is no need to amend it. Both the Middle and Western Districts of North Carolina have come to decisions at odds with *Precision Walls* in the *Jones* and *Mason Dixon* cases.

**IX. STATUTORY LIEN ARGUMENTS PRESERVED**

United Rentals did preserve its statutory lien argument for appeal. Joint Appx. at 181, 186-87 (Final Pre-trial Order, at pp. 2, 7-8).

**CONCLUSION**

It is not in dispute that United Rentals has a defense in the contemporaneous exchange of bond rights, even though no notice of claim was given and no lawsuit filed. There is no other case like *Precision Walls*, stating that no such defense exists. The defense was recognized by the Bankruptcy Court in this case.

The only difficulty to the Bankruptcy Court in this case was United Rentals' need to prove that it would have perfected or enforced those bond rights. This burden was improperly put on United Rentals. The Transfer payments alleviated the need to and made it impossible to perfect or enforce. The Transfer payments automatically discharged United Rentals' bond rights and contemporaneously increased the estate's assets. The estate was not diminished as a result. There is no case law to the contrary supporting the Trustee's position herein that United Rentals needed to prove that it would have perfected or enforced those bond rights, other than unpublished opinions from this Bankruptcy Court.

United Rentals met even this affirmative defense burden of proof, with no contrary evidence from the Trustee. Accordingly, United Rentals respectfully

prays that it be granted judgment in this case and that the Complaint against it be dismissed with prejudice.

The more difficult question in this case is the burden of proof initially. The Trustee had the burden to prove Transfers did not result in payments greater than United Rentals would have received in a Chapter 7 liquidation and did not diminish the estate. The Trustee did not meet this burden in motion for summary judgment or at the trial. Accordingly, United Rentals respectfully prays that it be granted judgment in this case and that the Complaint against it be dismissed with prejudice on the grounds these grounds as well. At a minimum, summary judgment should not have been entered in favor of the Trustee.

Respectfully submitted this the 15th day of June, 2009.

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UNITED STATES COURT OF APPEALS  
FOR THE FOURTH CIRCUIT

No. 09-1209

Caption: United Rentals, Inc. v. James B. Angell, Chapter 7 Trustee

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(s) James D. Fullerton

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Dated: 6/15/09

## CERTIFICATE OF SERVICE

### All Case Participants Are CM/ECF Participants

I hereby certify that on June 15, 2009, I electronically filed the foregoing with the Clerk of Court using the CM/ECF System, which will send notice of such filing to the following registered CM/ECF users:

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